UNITED STATES. CONGRESS. HOUSE. COMMITTEE ON THE JUDICIARY.
" SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW.

BANKRUPTCY REFORM ACT OF 1999
(PART I)

HEARING

BEFORE THE

SUBCOMMITTEE ON
COMMERCIAL AND ADMINISTRATIVE LAW

OF THE

COMMITTEE ON THE JUDICIARY
HOUSE OF REPRESENTATIVES

ONE HUNDRED SIXTH CONGRESS

SECOND SESSION

ON

H.R. 833

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HEARING DATE

BANKRUPTCY REFORM ACT OF 1999, PART I

TUESDAY, MARCH 16, 1999

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COMMERCIAL
AND ADMINISTRATIVE LAW,
COMMITTEE ON THE JUDICIARY,
Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m., in Room 2141, Rayburn House Office Building, Hon. George W. Gekas [chairman of the subcommittee] presiding.

Present: Representatives George W. Gekas, Steve Chabot, Asa Hutchinson, Jerrold Nadler, John Conyers, Jr., Melvin L. Watt, William D. Delahunt, Tammy Baldwin, and Anthony D. Weiner.

Also present: Raymond V. Smietanka, Subcommittee Chief Counsel; Susan Jensen-Conklin, Subcommittee Counsel; James W. Harper, Subcommittee Counsel; Peter Levinson, Full Committee Counsel; Audray Clement, Subcommittee Staff Assistant; and David Lachmann, Minority Professional Staff Member.

OPENING STATEMENT OF CHAIRMAN GEKAS

Mr. GEKAS. The hour of 10 o'clock having arrived, the hearing of the Subcommittee on Commercial and Administrative Law of the Committee on the Judiciary on the subject of bankruptcy reform will come to order. But since there are no witnesses ready to testify and because we require the presence of at least one other member to constitute a hearing quorum, we will recess until one of those contingencies should occur.

We stand in recess.

[Recess.]

Mr. GEKAS. The time of the recess has artificially expired because we have noted the presence of the gentleman from Virginia, Congressman Boucher, who has been a staunch supporter and original cosponsor of the effort on bankruptcy reform that was begun last term and which is continuing with gusto this term. As soon as he arrives, we will let you know.

But in the meantime, we will seize the gavel for the purpose of accommodating Representative Boucher and a member's statement that he has prepared for the record.

With that, we recognize the gentleman from Virginia.

STATEMENT OF HON. RICK BOUCHER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF VIRGINIA

Mr. BOUCHER. Thank you very much, Mr. Chairman. It gives me a great deal of pleasure to be here this morning to say that I am pleased to be participating with you in what I hope will be the first of many bipartisan exercises by this committee during the course of the 106th Congress. And it is fitting, indeed, that this bipartisan exercise occurs on the highly important subject of bankruptcy reform.

In an era when disposable incomes are growing, when unemployment rates are low, and when the economy is strong, consumer bankruptcies should be rare. Contrary, however, to this expectation, in 1998 there were 1.4 million personal bankruptcies filed, and that was an increase of 40 percent above the number in 1996 when the number of filings exceeded 1 million for the first time.

Bankruptcies of convenience are driving this increase. Bankruptcy was never meant to be used as a financial planning tool, but it is becoming the first stop rather than a last resort as many filers who can repay a substantial portion of what they owe use the complete liquidation provisions of Chapter 7 rather than the court-supervised repayment plans contained in Chapter 13.

Our legislation will direct more filers into Chapter 13 plans. This is a consumer protection measure. The typical American family pays a hidden tax of about $550 per year arising from the increased costs of credit and the increases in the prices of goods and services occasioned by the discharge of $50 billion each year in consumer debt arising from bankruptcy proceedings. By requiring that people who can repay a substantial part of their debt do so by using Chapter 13 plans, we will lessen that hidden tax.

Another key point should be made about the provisions of our bill. The alimony or child support recipient is clearly better off under our bill than that person is under current law. At the present time, the child support or alimony recipient stands seventh in the rank of priority for payment of claims in bankruptcy. She is behind farmers making claims against grain elevators. She is behind fishermen making claims against warehouses.

Under our bill, the child support or alimony recipient will receive priority number one in the distribution of the bankrupt's estate. Her claim will be first in line for payment, and other provisions also make it easier for her to execute against the assets of the bankrupt's estate than is the situation under current law.

Last year, this measure, when considered as a conference report, received 300 votes on the floor of the House, reflecting a broad bipartisan agreement that this reform is necessary. It truly is a bipartisan measure, and I want to commend you, Chairman Gekas, for introducing the bill promptly during the course of this Congress, scheduling this series of hearings in a very timely manner, and I look forward to working with you as we obtain reporting of this measure by the full Judiciary Committee and approval of the measure on the floor of the House of Representatives.

The time has come for this much needed reform, and I truly believe that with your leadership and with our shared effort, the 106th Congress will be the time when that reform is achieved.

Mr. GEKAS. We thank the gentleman, and we note what he noted, that the bipartisan flavor of this legislation is reflected not only in the votes cast during the last Congress but in the new cosponsorship of the new bill in the current session, of which, of course, the gentleman from Virginia is a prime figure.

So we thank you, and we excuse you to run around, do your errands, and we will see you on the floor.

Mr. GEKAS. We now recognize the gentleman from Michigan, Representative Nick Smith, who, I must say, in the last Congress and in the first stages of this Congress, has been very active—some would say overactive—in the pursuit of his quest that Chapter 12 of bankruptcy never falls behind in the consideration by the Congress and is very insistent that a fail-safe measure on Chapter 12 be passed into law pending the outcome of the full bankruptcy reform proposals that we have before us. So we congratulate him on his continuing effort, and we say to the gentleman that he may proceed to give his opening statement. His written statement will become a part of the record.

We note the presence of a working quorum, a hearing quorum, and the presence of the gentleman from Massachusetts, Mr. Delahunt, the gentleman from North Carolina, Mr. Watt, and the gentleman from New York, Mr. Nadler. With that, we——

Mr. WATT. I call for a recorded vote, Mr. Chairman.

Mr. GEKAS. Pardon me?

Mr. WATT. I call for a recorded vote.

Mr. GEKAS. I don't know what that means.

Mr. WATT. I want to vote right now while we got the majority. [Laughter.]

Mr. DELAHUNT. This is probably the best shot we have.

Mr. GEKAS. We can vote on whether you want to continue with listening to the members. I might vote no.

Mr. WATT. We might all vote no. [Laughter.]

Mr. GEKAS. Representative Smith is recognized for 5 minutes.

STATEMENT OF HON. NICK SMITH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Mr. SMITH. Mr. Chairman and committee, thank you very much, and thank you for passing out my bill H.R. 808 to give a momentary extension on the Chapter 12 provisions.

Some comments in general. When I came to Congress 6 years ago, about 5 years ago, I introduced a bankruptcy bill because it seemed to me that we in our effort to be fair to those that were having financial difficulties, we were ending up increasing the cost and the availability of financing to farmers and others simply because of the nervousness or weariness of lenders to lend out that money.

In general, our bankruptcy laws as a whole, I agree with this committee, are badly in need of reform. An interesting statistic: During only 6 months of 1998, more bankruptcies were filed than during the entire Great Depression. By declaring bankruptcy, sometimes it has become too easy for debtors to skirt their financial obligations. It is not unreasonable that we should ask those who can afford to pay some of their unsecured, non-priority debts to do so. But the bottom line, as I see it out in my area of Michigan, is that by providing too much protection in the bankruptcy courts, the result is less availability and higher cost of borrowing for everybody else.

Specifically, a couple comments on Chapter 12. That is the chapter that is only available to family farms. The traditional definition of the family farms of $1.5 million of debt I think needs to have consideration for expansion upward of the $1.5 million. The current provisions, not less than 80 percent of that debt be related to agricultural activity, needs a new look-see. As family farms grow bigger and expand and because of the near disastrous situation that we have experienced in this last year of low commodity prices as well as natural weather disasters, we have a lot of farmers across the country that very well may be declaring bankruptcy in the near future. Those are the kinds of farmers that are good farmers, that have cut down on their employment and simply work longer hours trying to get them through this period of lower demand partially because of the Asian crisis, partially because of other reasons. These farmers need some consideration to not be forced to sell their tools that are their only means of getting back in the game, if you will, to survive in agriculture.

So I compliment the committee for looking at the overall bankruptcy provisions and particularly want to urge you to continue examining the Chapter 12 provisions to accommodate the larger family farms that don't meet the particular specifications that we passed in the original family farms, commonly called the Chapter 12 provisions.

I thank the committee for the opportunity to give you my comments this morning.

Mr. GEKAS. We thank the gentleman, and we excuse him, with our gratitude. And as we have noted to him personally before, he should remain in close contact with the Chair to mark the developments in this reform measure as it pertains to Chapter 12 and the other segments of the reform effort.

Mr. SMITH. And I will keep in close contact with the Chair and certainly also Mr. Nadler, who has an appreciation for our agricultural problems.

Mr. NADLER. Mr. Chairman, I have some questions of Mr. Smith.

Mr. GEKAS. The custom when we have members—of course, we can breach the custom any time we want to—is to dismiss them so that they don't have to stay.

Mr. DELAHUNT. I just have one quick question.

Mr. GEKAS. The gentleman from Massachusetts.

Mr. DELAHUNT. I respect the gentleman and I know what he is doing on behalf of family farmers. Coming from a coastal district in Massachusetts, the experience that your constituents are unfortunately going through at this point in time is exactly—it is being replicated exactly by fishermen in coastal regions. At some point in time, I would like to talk to you possibly about amending your legislation or amending the bill here, because what we are seeing is families that have been engaged in fishing for generations in Massachusetts and all up and down the Atlantic coast and presumably the Pacific coast who are experiencing extremely difficult times because of the depletion of fishing stocks.

Again, I think what you are doing obviously deserves serious consideration.

Mr. SMITH. Mr. Delahunt, maybe I need a refresher, but it used to be that fishermen were included in the agricultural sick code, and I don't know if they are included in Chapter 12 or not. But it deserves consideration.

Mr. DELAHUNT. Thank you. I don't know and that is a good point. But thank you, Mr. Smith.

Mr. GEKAS. The gentleman from New York?

Does the gentleman from Michigan wish to submit himself to one comment or question from the gentleman from New York?

Mr. NADLER. I have a couple questions for the gentleman from Michigan.

First of all, I want to commend the gentleman from Michigan for his industry and persistence on this question of Chapter 12 renewal.

Congressman, you sponsored, I cosponsored last year a 2-year extension of this bill. We had, of course, a bill that was originally 3 months, then it was 6 months, that we reported out. Last year we actually had this Chapter 12 actually sunset for a few weeks, I think it was, and now we are doing a 6-month extension.

I just want to ask what you think, if there is any good reason we shouldn't be doing a 2-year or longer extension, why we should be doing these 3-month, 6-month extensions so that this can be hostage to the more controversial provisions of the omnibus bill.

Mr. SMITH. I guess, Mr. Nadler, it would be my impression that if we are not successful in getting the total bankruptcy reform package out this year, let's quit playing games with it and let's make Chapter 12 permanent.

Mr. NADLER. I would agree with you, and I hope we would do that.

Let me just ask one other question. The provisions in Chapter 12 for family farms—and let me say, by the way, I have a particular affinity for this because I spent 8 years of my childhood on a family farm in New Jersey which my parents owned, and perhaps one of the reasons I became a Democrat—it is hard to say that far back, but I knew when I was 8 or 9 years old that there were two really nasty people in the world. One was named Dwight Eisenhower, and the other was named Ezra Taft Benson, who was the Secretary of Agriculture. I wasn't sure what they did that was nasty, but they seemed to have it in for my father and for other small chicken farmers for some reason.

But in any event, I saw the problems that could be caused, and we lost the farm—my parents lost the farm to foreclosure over 40 years ago, and I remember that very clearly.

I just want to ask you one thing. Some of the provisions of this for Chapter 12 are considerably—in fact, the Chapter 12 provisions are considerably more favorable to debtors than are the provisions in Chapter 13 for non-farm debtors, and this bill would make the provisions in Chapter 13 far harsher for debtors.

Do you think there is a good reason to treat them differently, in other words, to be having what I would call a reasonable system for farm debtors and a very harsh system for non-farm debtors?

Mr. SMITH. Well, when I was in the Michigan Legislature, I introduced provisions for welfare payments not to force carpenters, for example, to sell their tools, to be eligible for some temporary relief on welfare. And I think the question of forcing a person to sell their tools of trade that is going to give them the best chance of recovering is reasonable, whether it is the carpenter or the fisherman or the farmer.

I continue to believe that this should be limited to the small family farmer that is having the most difficulty surviving, and so I would hope we would keep our provisions in that most of their income has to come from agriculture. It can't be somebody that is playing games with the advantages of the Bankruptcy Code here just because they have a country estate.

Mr. NADLER. Thank you very much.

Mr. GEKAS. We thank the gentleman.

Mr. SMITH. Thank you.

[The prepared statement of Mr. Smith follows:]

PREPARED STATEMENT OF HON. NICK SMITH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

I appreciate the opportunity to appear today before the Subcommittee on Commercial and Administrative Law to discuss an issue of significance for America's families—the Bankruptcy Judges, United States Trustees and Family Farmer Bankruptcy Act of 1986, commonly known as Chapter 12. I would like to thank this committee for passing my bill, H.R. 808, that extends the provisions of Chapter 12.

In general, our bankruptcy laws as a whole are badly in need of reform. During only 6 months of 1998, more bankruptcies were filed than during the entire Great Depression. By declaring bankruptcy, it's become too easy for debtors to skirt their financial obligations. Bankruptcy law, which is supposed to balance the rights of creditors with the notion that a bankrupt debtor should be allowed a "fresh start," has become a form of un means-tested welfare. It is not unreasonable that we should ask those who can afford to pay some of their unsecured, non-priority debts to do so. By providing too much protection in the bankruptcy courts, the result is less availability of funds and a higher cost of borrowing for everyone else.

Chapter 12 is a form of bankruptcy relief only available to "family farmers" which allows these producers the option to reorganize debt, rather than having to liquidate, when declaring bankruptcy. A family farmer is an individual with over 50 percent of gross income derived from agricultural. To qualify under Chapter 12, producers must have under $1.5 million in debt, with not less than 80% of that debt related to agricultural activity.

Chapter 12 was enacted temporarily to respond to the farm crisis in the 1980's and was scheduled to sunset September 30, 1998. Last October, Congress extended Chapter 12 for another six months as part of the Omnibus Consolidated and Emergency Supplemental Appropriations Act. Today, Chapter 12 is scheduled to expire March 31, 1999. Last week, the House passed my bill H.R. 808, to temporarily extend Chapter 12 provisions for another six months. It is my hope that the Senate will soon act upon this legislation so we can send it to the President before the expiration date.

As you are all aware, times are very tough in farm country these days. While the rest of the economy is booming, America's farmers and ranchers have been reeling from a series of disasters related to historically low commodity prices, shrinking export markets, and bad weather. While credit is available to qualified borrowers and the farm credit system is currently sound, there are some producers who just won't be able to make ends meet in the short term—some bankruptcy filings are inevitable.

Not only should Congress not let Chapter 12 expire, these provisions should be made permanent. I am pleased to see that H.R. 833, the Bankruptcy Reform Act of 1999 does this. The cyclical nature of ranching and farming means that inevitably, producers will face periods of severe economic downturns. Rather than having to craft special legislation to deal with these periods, general bankruptcy protection for farmers should always be available, just as Chapter 13 is for consumers.

While Chapter 12 needs to be made permanent, which assures producers that this risk management tool will be available, modifications are needed to modernize it for the next century. Because it is not uncommon for family farmers to carry debt above $1.5 million, the debt ceiling should be extended to at least $2 million. This would assure that the majority of family farmers still have the option to use Chapter 12 if they have to. Also, only producers who were qualified family farmers the previous taxable year are now eligible to use Chapter 12. I would recommend extending that period to two years. This would include family farmers who for whatever reason did not qualify under the legal term one of the two taxable years.

I am glad to see that the committee is tackling general bankruptcy reform and again, I appreciate the opportunity to appear before you. I look forward to moving ahead on this processes and I would be happy to answer any questions you might have.

Mr. GEKAS. Now we turn to the lady from Texas, Representative Sheila Jackson Lee, who, in the last Congress, entered the debate on bankruptcy reform very early, and I must say remained in a debating mode straight through to the end of the session last time, and here she is beginning on this year's schedule to participate in the debate on bankruptcy reform. We recognize the lady for 5 minutes.

STATEMENT OF HON. SHEILA JACKSON LEE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Ms. JACKSON LEE. Thank you, Chairman Gekas, very much and to ranking member Nadler, both of you, for your leadership on what is a very important issue.

First, Mr. Chairman, let me acknowledge my participation in this issue and legislative initiative last Congress, and as well my participation on the conference committee. I say that because this year, this Congress, I hope that we will strike a chord of reconciliation to the point that bankruptcy is not a partisan issue or the needs of those who file bankruptcy and, in fact, will take this opportunity, the 106th Congress, to assure that we can find common ground.

I truly believe in the unfettered access to credit and the responsibility in the utilization of credit. I hope, however, that the issues that I bring before you under H.R. 833, we can find a way to respond to some of my concerns.

Let me start out by noting that there are well over a billion credit cards in circulation, a dozen credit cards for every household in this country. From 1994 through 1996, credit card issuers mailed more than 2.5 billion card solicitations each year. In 1997, mail credit card solicitations jumped by 20 percent to 3 billion.

I provide that data simply to say that there are not good and bad, there is not right and wrong. There is right on all sides and wrong on all sides. In particular, I would say to my friends in the credit card industry that we must work together to realize that the unsolicited submission of credit cards does in some way hasten some of the ills and problems that many of our citizens have had.

So I come not to divide the committee but, more importantly, to see that we can come together. I would also offer, however, the thought that haste makes waste, and I hope that we will take the time to have extensive hearings. I do note that there is a full hearing today with representatives from the consumer element and that there will be hearings further on this week.

Individuals with the financial ability to pay their financial obligations should be required to pay. Certainly no one is suggesting that the Bankruptcy Code should provide a shield for individuals interested in defrauding creditors. Unfortunately, H.R. 833 and its provisions will create a modern-day debtor's prison through the use of reaffirmation agreements. Simply put, honest debtors will be coerced into signing away future earnings in an attempt to satisfy previous debt obligations.

Proponents of H.R. 833 claim that the bill's intent is to restore personal responsibility. However, one of the bill's thrusts is actually about the redirection of the money of bankruptcy filers, particularly Chapter 7 filers, to banks, credit card companies, and other credit lending institutions by making Chapter 13 almost mandatory.

The facts are that over 60 percent of all bankruptcy filers were unemployed at some time within the 2-year period prior to their filing—legitimate reasons for moving into bankruptcy. But instead of helping people, H.R. 833 redirects a significant portion of debtors' income to banks and credit card companies and, in turn, will hurt a lot of women and children who are dependent on child and spousal support.

It is ironic that the consumer lending industry actively solicits unsuspecting consumers through the mail with terms of easy credit, buy now or pay later. And then after addicting debtors to this "financial crack," lenders are advocating for reform. Of course, debtors are responsible for financial obligations, Mr. Chairman, and I totally agree that we have got to get a grip on this problem. It would be interesting, and I hope that we will have economic studies to find out in the last 2 years of a good economy whether or not we have had that peaking of filing, and that will be something that we should be concerned about.

Several commentators have suggested that consumer lenders have begun to relax their underwriting guidelines to increase market share. In our testimony last year, we determined that even though credit card companies are looking for reform, they have had only 4 percent default in debt. Additionally, we know that the National Bankruptcy Review Commission could not decide on the value of means-testing as to whether or not that really works.

I am for bankruptcy legislation that is fair, legislation that recognizes the importance of a debtor's financial obligation. In 1997, the average bankruptcy filer had a debt-to-income ratio of 1.25 to 1, 125 percent of their income, as opposed to just a few years ago 0.74 to 1, a few short years ago.

According to Bankruptcy Law Professor Elizabeth Warren of the Harvard Law School, the debtors that enter bankruptcy are usually experiencing turbulent times. Sixty percent of bankruptcy filers have been unemployed within a 2-year span prior to their filing, and 20 percent of filers have had to cope with an uninsurable medical expense.

We need to protect women and children in this process, Mr. Chairman, and according to the Consumer Bankruptcy Project, an estimated 300,000 bankruptcy cases involve child support and alimony. In Chapter 7, alimony and child support payments survive; consequently, women and children are benefitted when the debtor can discharge other financial obligations in order to make payments on non-dischargeable debts.

H.R. 833 creates a broader category of non-dischargeable debt, thus lowering the potential for women and children to receive necessary support payments for their existence. Mr. Chairman, women and children would be in direct competition for the limited resources of the discharged debtor. I do not see why we cannot collectively come together, Mr. Chairman, and ensure that we protect them.

Let me close by saying this: The means test is an artificial formula that has its genesis in a discretionary living expenses equation as determined by the Internal Revenue Service collection standards. Mr. Chairman, if we are not using the IRS as standards for other valuable decisions that this Congress makes, I don't know why we would do so and then place that burden upon our constituents. I do believe that we can work together, and I thank Ranking Member Nadler for his leadership. I happen to support legislation helping our family farmers. There is a lot of common ground. But there are a lot of problems with H.R. 833 that should be fixed.

I would say finally, Mr. Chairman, that although I applaud the consumer provisions of educating our consumers in H.R. 833, might I caution you to consider the fact that some of the help that will come to these most desperate consumers are by paid fees. And I would like to see those fees being paid by the industry and opening up consumer counseling and education to all the world, if you will, because we all have a problem with consumer credit. And I hope, Mr. Chairman, we can work together.

Mr. GEKAS. We thank the lady, and we assure her that her written statement will become a part of the record.

[The prepared statement of Ms. Jackson Lee follows:]

PREPARED STATEMENT OF HON. SHEILA JACKSON LEE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Thank you Chairman Gekas and Ranking Member Nadler for giving me this opportunity to come before this committee and express my concerns about H.R. 833, the Bankruptcy Reform Act of 1999.

During the 105th Congress, I served as a member of this distinguished committee and as a conferee on the Bankruptcy Reform Act of 1998. I come before you today, not as a Democrat but as an individual concerned about the potential impact this legislation will have on America's families—most importantly, children.

I come not to divide the committee but asking for temperance and deliberateness in the development of legislation aimed at reforming the bankruptcy system. I am reminded of the time-tested adage, that "*haste makes waste*." This committee must exercise its authority to enact legislation in a cautious manner to do otherwise is improvident and irresponsible.

Individuals with the financial ability to pay their financial obligations should be required to pay. Certainly, no one is suggesting that the bankruptcy code should be provide a shield for individuals interested in defrauding creditors. Unfortunately, H.R. 833 and its draconian provisions will create a modern day debtor's prison through the use of reaffirmation agreements. Simply put, honest debtors will be coerced into signing away future earnings in an attempt to satisfy previous debt obligations. Proponents of H.R. 833 claimed that the bill's intent is to restore personal responsibility. However, one of the bill's thrusts is actually about the redirection of the money of bankruptcy filers, particularly Chapter 7 filers, to banks, credit card companies and other credit lending institutions by making Chapter 13 almost mandatory.

The facts are that over 60% of all bankruptcy filers were unemployed at sometime within the two-year period prior to their filing. But instead of helping people, H.R. 833 redirects a significant portion of debtors income to banks and credit companies, and in turn, hurt a lot women and children who are dependent on child and spousal support.

It is ironic that the consumer lending industry actively solicits unsuspecting consumers through the mail with terms of easy credit, buy now—pay later jargon. And then after addicting debtors to this "*financial crack*" lenders are advocating for reform. Of course debtors are responsible for financial obligations they incur; however, lenders must assume responsibility for their actions in creating the precarious financial crisis we are discussing.

Several commentators have suggested that consumer lenders have begun to relax their underwriting guidelines to increase market share because of the profitability of credit cards. Bankruptcy Reform must call for responsibility from everyone with an interest at stake. Congress must end the *"financial entrapment"* of debtors who lack financial sophistication.

I am for bankruptcy legislation that is fair—legislation that recognizes the importance of a debtor's financial obligation to his family while balancing the debtor's obligations to his creditors. Debt relief must be available for debtors whose debts exceed their ability to repay their financial obligations. In 1997, the average bankruptcy filer had a debt to income ration of 1.25 to 1 (125% of their income) as opposed to just .74 to 1 (74% of their income) a few short years ago.

According to Bankruptcy Law Professor Elizabeth Warren of the Harvard Law School, the debtors that enter bankruptcy are usually experiencing turbulent times. 60% of bankruptcy filers have been unemployed within a two year span prior to their filing. 20% of filers have had to cope with an uninsurable medical expense. Approximately 1.5 individuals out of every three bankruptcy filers, are recently divorced.

We must protect women and children. According to the Consumer Bankruptcy Project, an estimated 300,000 bankruptcy cases involved child support and alimony orders. In Chapter 7 alimony and child support payments survive; consequently, women and children are protected when the debtor can discharge other financial obligations in order to make payments on non-dischargeable debts.

H.R. 833, creates a broader category of non-dischargeable debt; thus, lowering the potential for women and children to receive necessary support payments for their existence. Mr. Chairman, women and children would be in direct competition for the limited resources of the discharged debtor.

We must protect women and children. Imagine women and children standing in line with credit card issuers, retail stores, installment stores and other unsecured creditors waiting for alimony and child support payments from a post-discharged debtor. H.R. 833 places women and children on equal footing with other creditors. Women and children do not have the ability to charge an interest of 23% or request late fees from a debtor but credit card companies and other unsecured creditors can and do. This bill is a catastrophic threat to our families who rely on support payments.

The "means test" is an artificial formula that has it genesis in a discretionary living expenses equation as determined by the Internal Revenue Service collection standards. This mathematical formula will ignore in many cases or understate the real expenses, financial and personal circumstances of the debtor. H.R. 833 is unacceptable because it will force bankruptcy filers into Chapter 13 pursuant to an arbitrary and capricious formula that is harsh and extreme. The damage of trying to accomplish this goal through a "means test" might be irreparable. The National Bankruptcy Review Commission rejected the means test formula. Simply stated, the "means test" is a mean test because it will hurt women, children and honest debtors who are looking for a fresh start.

If we deny access to Chapter 7 to the wrong debtors, and those debtors fail to complete required repayment plans, they will return to Chapter 7 with a diminished capacity to repay their non-dischargeable debt—including child support and alimony. The "means test" advocates a *cookie-cutter* mentality to an individual problem. Bankruptcy legislation must take into account the specific needs of the debtor, his financial obligation and the ability to repay financial obligations.

Bankruptcy courts must have the plenary authority to consider the specific circumstances of the debtors that come under their jurisdiction.

Congress must provide adequate safeguards to prevent debtors from being "pushed into" Chapter 13—because the bright-line test has been satisfied without thoroughly reviewing the individual's ability to pay. H.R. 833—would severely restrict the availability of debtors to seek protection utilizing State exemption laws. Texas law provides debtors with unlimited homestead exemption protection.

H.R. 833—fails to protect the interest of women and children! This draconian bill subrogates the alimony of former spouses and child support payments to the debtor's unsecured debt interest. Bankruptcy reform must ensure that a debtor's domestic obligations have the highest priority.

Unfortunately, H.R. 833—falls short of protecting America's most vulnerable citizens—women and children. It is essential that bankruptcy reform protect post-bankruptcy domestic support payments. Forced participation by a debtor in a plan requiring contributions from future income sources has little probability for success. It is critical that we have additional time to consider the long-term consequences of bankruptcy reform. This committee can not offer legislation that is a mirror image of last year's conference report.

Bankruptcy legislation must protect the rights of families, as well as guarantee a fresh start for honest debtors. The days of debtors' prison have faded into America's history but there appears to be a movement afoot to attach financial obligations to a debtor for an indefinite period of time regardless of the ability to pay.

H.R. 833 would force a debtor to carry his debt responsibility as an eternal albatross. The President, 110 federal bankruptcy judges and a coalition of bankruptcy law professors opposed this approach to bankruptcy reform. We must protect women and children. I have reservations about creating non-dischargeable debts that could set in opposition post- bankruptcy, credit card debt against child support, alimony payments, educational loans, and taxes.

We must protect women and children. Although H.R. 833 suggests that alimony and child support payments are priority obligations, women and children are in competition with secured creditors for the debtor's financial resources.

We must protect women and children. H.R. 833 instead creates a hierarchy system that gives secured creditors the highest priority while family obligations are secondary interests to be paid—after secured creditors.

The greatest challenge before us in the bankruptcy reform efforts of the 106th Congress is solving the widely recognized inadequacies of the law in the area of consumer bankruptcy. As it has always been in the Congress, the key to this process, is, of course, successfully balancing the priorities of creditors, who desire a general reduction in the amount of debtor filing fraud, and debtors, who desire fair and simple access to bankruptcy protections when they need them.

I also want to thank Congressman Jerrold Nadler, the distinguished gentleman from New York and the Ranking Member on the Subcommittee on Commercial and Administrative Law. He has been a leader and a strong advocate these past two years for the consumer. He has been on the battlefield, and I have been there with him to insure that women and children are not locked out, that debtors receive equal and balanced treatment, and that there is true bankruptcy reform.

Thank you.

Mr. GEKAS. We turn to the lady from New York who has just joined us, Representative Slaughter, whose written statement will become a part of the record and from whom we will hear for 5 minutes. Thank you.

STATEMENT OF HON. LOUISE McINTOSH SLAUGHTER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Ms. SLAUGHTER. Thank you, Mr. Chairman.

Mr. Chairman, Mr. Nadler, Mr. Delahunt, thank you very much for allowing me to offer my views this morning on the bankruptcy bill.

Just 5 years ago, I introduced the Spousal Equity in Bankruptcy Amendments to give priority to child and spousal support payments in bankruptcy proceedings. That legislation became law as a part of the Bankruptcy Reform Act of 1994. Thanks to those and other child support enforcement reforms, child support collections have increased by about 70 percent since 1992.

I regret to say, however, that the bill the subcommittee is now considering would reverse the progress we have made in recent years. In its current form, this bill will have a damaging impact on women and children who are owed child support and alimony.

By making large amounts of consumer debt non-dischargeable in bankruptcy, the bill will make alimony and child support compete against money owed on credit cards. After a debtor goes through bankruptcy proceedings under this bill, he or she will still have credit card and other types of consumer debts left to pay, and those debts will compete with child support and alimony for the limited resources of the debtor. The bill will effectively take us back to the days when the Bankruptcy Code gave child support and alimony no greater importance than the purchase of a television set or jewelry with a credit card.

The proponents of the bill claim to have repaired the damage the bill does by including provisions that strengthen the rights of child support collection agencies and raise the priority of child support and alimony in bankruptcy proceedings. Those provisions are well-intentioned, but they do not overcome the damage done by the bill. The provisions ignore the reality that after bankruptcy proceedings are over, the bankrupt debtor will be left with additional credit card and consumer debt. And when aggressive credit card collection agencies are calling, it will be easier to pay them rather than the former spouse or the powerless child.

This bill is tough on families in distress. But it fails to deal effectively with the root cause of rising bankruptcy rates, which is the easy availability of credit. The bill requires lenders to make additional disclosures, and it encourages creditors to make good-faith settlements with debtors before bankruptcy. But it does nothing to discourage lenders from offering credit to borrowers who are literally already head over heels in debt.

The fact that we each receive about five credit cards in the mail every week shows us the availability of it and that nobody is watching.

The Consumer Federation of America reports that in recent years the credit card industry has stepped up its marketing to low- and moderate-income individuals and, most importantly, to minors. In 1997, the amount of credit card debt carried over from month to month rose above $450 billion—double what it was just 5 years ago. In just 1 year, 1996, credit card debt grew three times faster than incomes. As a result, nearly 60 million American households carry credit card balances averaging more than $7,000, costing these households more than $1,000 a year in interest and fees. This growing credit card debt is the main reason for the rise in personal bankruptcies.

H.R. 833 is opposed by children's rights advocates and women's groups who are concerned about the damage it will do to children and families in crisis. It is also opposed by labor unions, consumer groups, public interest groups, and judges, lawyers, and scholars who are concerned about the integrity of the bankruptcy process.

We must not make it harder for non-custodial parents to pay child support. We should not be placing new obstacles in the way of a parent's ability to pay support. In my county—Monroe County, New York—more than $135 million in past-due child support is owed to 41,000 children. The numbers are similar for New York State as a whole. And of the over $1 billion owed in child support in 1997, only about $800 million was collected. The accumulated total child support arrears owed in my State is $3 billion. Across the Nation, the gap between potential child support and actual child support collected is estimated to be $34 billion.

I support efforts to reform our bankruptcy laws to make debtors responsible for the debt that they incur. But if we want to reduce bankruptcy rates, we have to attack the root cause, which is the easy availability of enormous lines of consumer credit. And in the process of doing so, we need to protect the interests of the most vulnerable parties.

I urge the subcommittee to address the problem with this bill that it creates for women and children who are owed child support and alimony. And I urge the subcommittee to seek a balanced approach to bankruptcy reform that prevents abuses of the bankruptcy system, while allowing the good-faith debtors the ability to take care of their families while they deal with their debts.

And, Mr. Chairman, I would like to—we are working on an amendment to require that the statement of terms and conditions on credit card applications be written at least as large as the smallest print in the ad itself.

I thank you very much for your kind attention.

Mr. GEKAS. We thank the lady, and we will be glad to review her proposed amendment any time she wishes to submit it to us and to the minority.

Ms. SLAUGHTER. I thank you very much.

[The prepared statement of Ms. Slaughter follows:]

PREPARED STATEMENT OF HON. LOUISE MCINTOSH SLAUGHTER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Mr. Chairman, Mr. Ranking Member, members of the Subcommittee: thank you for allowing me to offer my views on the bankruptcy bill that you are now considering.

Just five years ago, I introduced the Spousal Equity in Bankruptcy Amendments, to give priority to child and spousal support payments in bankruptcy proceedings. That legislation becaom law as part of the Bnakruptcy Reform Act of 1994. Thanks to those and other child support enforcement reforms, child support collections have increased by about 70 percent since 1992.

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Proponents of H.R. 833 claim to have repaired the damage the bill does, by including provisions that strengthen the rights of child support collection agencies and raise the priority of child support and alimony in bankruptcy proceedings. These provisions may be well- intentioned, but they do not overcome the damage done by the bill. These provisions ignore the reality that, after bankruptcy proceedings are over, the bankrupt debtor will be left with additional credit card and consumer debt. And when aggressive credit card collection agencies are calling, it will be easier to pay them rather than the former spouse or the powerless child.

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I support efforts to reform our bankruptcy laws to make debtors responsible for the debt they incur. If we want to reduce bankruptcy rates, we need to attack the root cause, which is the easy availability of enormous lines of consumer credit. And in the process of doing so, we need to protect the interests of the most vulnerable parties—the children who could be denied vital support.

I urge the Sbucommittee to address the problem this bill creates for women and children who are owed child support and alimony. I urge the Subcommittee to seek a balanced approach to bankruptcy reform that prevents abuses of the bankruptcy system, while allowing good-faith debtors the ability to take care of their families while they deal with their debts.

Mr. GEKAS. With that, we abruptly end the members' presentations for this session of the Commercial and Administrative Law Committee hearing, and we thank both our colleagues for their presentations. Their written statements will become a part of the record, as we have previously indicated. We thank them.

Ms. JACKSON LEE. Mr. Chairman, just a question on amendments. You are saying that we can submit the amendments during the course of the hearings that you will be having that we might want to propose?

Mr. GEKAS. You can submit them at any time to the majority and the minority for review for possible inclusion in the mark-up vehicles that are yet to come.

Ms. JACKSON LEE. Thank you, Mr. Chairman.

Mr. GEKAS. And if they are accepted right at the start, they will be part of the bill that we will be marking up. If they are not, you will still have the option as members to offer those amendments at mark-up.

Ms. JACKSON LEE. Thank you, Mr. Chairman.

Mr. DELAHUNT. Mr. Chairman, a point of information.

Mr. GEKAS. Yes, the gentleman from Massachusetts.

Mr. DELAHUNT. You know, the question of the gentle lady from Texas provoked another question from me to the Chair. I understand that there is a mark-up that is tentatively scheduled for next week. Or is that firmly scheduled?

Mr. GEKAS. That is on the schedule.

Mr. DELAHUNT. It is on the schedule.

Mr. GEKAS. Yes. We have it on the schedule, and we have notified everyone to that effect.

Mr. DELAHUNT. Great. Thank you.

Ms. JACKSON LEE. Thank you very much.

Mr. GEKAS. By all means.

We are ready now to listen to an opening statement by the gentleman from New York, which will be followed by a brief opening statement by the Chair, and then we will invite panel number one to take their places at the table.

Mr. NADLER. Thank you, Mr. Chairman.

Today we begin another hearing on bankruptcy legislation. I want to reflect, if I may, on the word "hearing." It implies that we are here to listen to the testimony and to the insights of experts in the field in order to inform our judgments and our actions. I would note that we have assembled over the next 3 days an impressive array of witnesses, including some of the most outstanding practitioners, scholars, and experts in the field. I refer not just to those witnesses requested by the minority, but also to those called by the majority, and I want to commend you, Mr. Chairman, for calling these outstanding individuals.

I hope that in the course of this hearing there will be some listening on the part of the members of the subcommittee, that this will not simply be a pro forma exercise on the way to a predetermined result. That would certainly be a waste of all of our time and a waste of the efforts of both the majority and the minority staff who worked very hard to put these hearings together.

It is for that reason, Mr. Chairman, that I was so troubled to read in yesterday's Congress Daily A.M. the following report, and I quote: "Gekas' office has made no secret of the fact that it believes the hearings likely will prove a rehash of issues already discussed last Congress and claim the meetings primarily are for the benefit of committee Democrats, like subcommittee ranking member Jerrold Nadler of New York, who are opposed to Gekas' approach."

"Commenting on the upcoming hearings, one Gekas staffer remarked, 'It will be a restatement for those who claim not to be up to snuff with knowledge.'"

I certainly hope this report reflects rather youthful staff bravado more than the chairman's oft-stated commitment to fulsome hearings. Yet I share the National Bankruptcy Conference's observation when the legislation before us was reintroduced, "Reintroduction of this omnibus bankruptcy bill is especially disappointing because it disregards the policy concerns expressed by the administration, over 20 groups representing the interests of women and children, civil rights groups, consumer advocates, along with a variety of other groups." Modestly omitting the membership of groups like the National Bankruptcy Conference, which represents the finest in the profession.

There has been a great deal of comment and insight and new studies since we considered this issue in the last Congress. We will hear from the authors of a study commissioned by the independent and non-partisan American Bankruptcy Institute, which shows that the studies funded by industries with a direct financial interest in this legislation, which we heard about last year, may have overstated the problem of individuals who are able to pay but do not by perhaps a mere 500 percent.

We will also hear from the General Accounting Office who will, at the request of the minority, provide a critical discussion of this and other studies on this topic, which I hope will help provide an important perspective to the members of the subcommittee.

There have been other new studies. For example, just last month the Federal Reserve Bank of New York issued a report that concludes that, "While these changes in personal characteristics and attitudes imply a higher risk of delinquency, we conclude that they are relatively unimportant in explaining the overall rise in bad debt. Much more important is the higher debt burden among cardholders: the new borrowers owe substantially more relative to their income, so even small drops in income can cause financial distress. Type of occupation also matters. The new borrowers are more likely to work in relatively unskilled blue-collar jobs; delinquency rates are higher among such workers, perhaps because their income is more closely tied to the business cycle. Greater indebtedness and the shift in cardholding toward people in more cyclical occupations help explain how such a mild economic slowdown in 1995 could have driven charge-offs so high today."

These findings seem to confirm the work of the FDIC, of Professor David Moss at Harvard, and Professor Larry Ausubel of the University of Maryland, who has previously testified before the subcommittee.

Similarly, in a recent paper, Professor Ausubel notes that the so-called bankruptcy crisis has actually responded to market forces and has seemingly evaporated without any of the proposed draconian changes to the Bankruptcy Code. According to Professor Ausubel, and I quote, "The bankruptcy crisis began in the first quarter of 1995, as the seasonally adjusted quarterly personal bankruptcy rate per thousand population—which had broadly been in decline since 1992—began to accelerate at a 12 percent annual rate. The crisis peaked from fourth quarter of 1995 to third quarter 1996, when the bankruptcy rate increased at a 30 percent annual rate for a full year. It then began a pronounced deceleration following the second quarter of 1997 as growth declined to less than a 4 percent annual rate. Today, there looks to no longer be a crisis: the personal bankruptcy filing rate per thousand population has grown at an annual rate of only 1.5 percent in the past year, and at a seasonally adjusted annual rate of only 1.0 percent in the past quarter."

Mr. Chairman, I ask unanimous consent that both the Federal Reserve and the Ausubel studies be made part of the record. And I also ask unanimous consent for an additional 1 minute, if I may.

Mr. GEKAS. Without objection—all except the 1 minute. You can have 2 minutes.

Mr. NADLER. Thank you.

[The studies referred to follow:]

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Meet the New Borrowers

Sandra E. Black and Donald P. Morgan

Credit card lenders have been writing off loans at sharply higher rates since 1995, suggesting that riskier borrowers are acquiring credit cards. What makes the new borrowers riskier—even more than their personal characteristics and attitudes toward debt—is the fact that they carry higher debt burdens and work in occupations where income may be more cyclical.

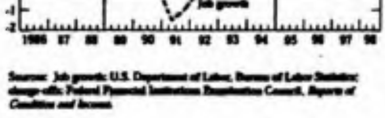
A democratization of credit cards is occurring in America.[1] According to the Survey of Consumer Finances, only 43 percent of U.S. households in 1983 had a MasterCard, Visa, or some other general purpose credit card.[2] By 1995, that share had jumped to 66 percent. Credit card carriers in the 1980s seemed like an elite club; now it seems that anyone can join.

Today's wider distribution of credit cards suggests that lenders are reaching out to riskier borrowers.[3] Credit card charge-offs—the bad loans that banks write off in a given year—turned upward sharply near the beginning of 1995 (see chart). Expressed as a percentage of all credit card loans, the annual charge-off rate rose to 6 percent in 1997—the highest in twenty-five years. The national slowdown in job growth in 1995 surely contributed to this rise in bad debt, yet charge-offs rose disproportionately and continued to rise even after job growth rebounded in 1996.[4] Even the slowdown in 1989, which ended in a recession, did not lead to as much bad debt as the mild slowdown did a few years ago. Something besides macroeconomic conditions is behind the rise in bad debt.

This edition of *Current Issues* investigates how the mix of cardholders has changed and identifies characteristics that seem to make the new borrowers riskier. Comparing data from the 1995 Survey of Consumer Finances with data from the 1989 survey, we find that cardholders in 1995 were more apt to be single, more likely to rent, and had less job seniority than cardholders in 1989. The new borrowers were also more willing to borrow, and to borrow for seemingly riskier purposes, such as vacation.

While these changes in personal characteristics and attitudes imply a higher risk of delinquency, we conclude that they are relatively unimportant in explaining

Credit Card Charge-offs and Job Growth



Sources: Job growth: U.S. Department of Labor, Bureau of Labor Statistics; charge-offs: Federal Financial Institutions Examination Council, *Reports of Condition and Income.*

the overall rise in bad debt. Much more important is the higher debt burden among cardholders: the new borrowers owe substantially more relative to their income, so even small drops in income can cause financial distress. Type of occupation also matters. The new borrowers are more likely to work in relatively unskilled blue-collar jobs; delinquency rates are higher among such workers, perhaps because their income is more closely tied to the business cycle. Greater indebtedness *and* the shift in cardholding toward people in more cyclical occupations help explain how such a mild economic slowdown in 1995 could have driven charge-offs so high today.

The Changing Mix of Cardholders

The Survey of Consumer Finances lets us view the new borrowers from several angles, including their personal characteristics, income, balance sheets, occupations, even attitudes (Table 1).[5] We use the 1995 survey—the most recent—and the 1989 survey. While data from 1995 may seem outdated, they are nearly ideal for our purposes. Credit card loans have to season for eighteen months or so before they go bad, implying that the charge-offs in the last year or two partly reflect the bad seeds in the 1995 crop of cardholders. Comparing cardholders in 1995 with those in 1989 is also ideal. Since the economy was slowing in both years, we are less likely to mistake differences in macro conditions for changes in the micro mix of cardholders. The only downside to the Survey of Consumer Finances is that the set of households covered changes over time. Since the set of households is not constant, we cannot identify exactly the *marginal* cardholder—the riskiest household that obtained a card sometime between 1989 and 1995. Instead, we look for changes in the *average* cardholder; if the average cardholder looks

Table 1
The Changing Profile of Cardholders

Borrower Characteristics	1989	1995	Borrower Characteristics	1989	1995
Cardholding and borrowing			Median stock and bond holdings	0	0
Percentage of all households with credit cards	55.8	66.5*	Mean holdings	$19,587	$28,802
Percentage with five or more cards	7.8	11.2	Liquid asset holdings[a]	$8,408	$4,700*
Limit on all credit cards	$6,000	$8,000	Debt as a percentage of income[b]	48.3	55.0*
Median credit card balance	$122	$200*	Debt payments as a percentage of income[c]	12.1	10.7*
Mean balance	$1,134	$1,871	Percentage of cardholders in occupations		
Personal characteristics			Executive/manager	31.5	25.8*
Age of head of household	45	46	Sales/administrative support	19.6	19.3
Percentage married	66.7	61.0*	Service	4.5	6.3*
Percentage owning a home	70.7	67.3*	Precision production/repair	11.9	9.9*
Median years at current address	9.0	6.0*	Operators/laborers	7.3	12.5*
Mean number of years	11.8	11.1	Farmers	1.3	1.8
Median years at current full-time employer	4.0	4.0	Retired	16.0	18.1
Mean number of years	7.9	7.4*	Not working	23.8	24.6
Income, assets, and debt			Percentage of cardholders who think it is "all right" to borrow for		
Family income	$42,083	$38,000*			
Percentage earning less than $10,000	4.7	6.8*	Vacation	13.3	17.3*
$10,000-$24,999	17.5	21.3*	Living expenses when income is cut	40.1	44.0*
$25,000-$49,999	36.4	30.3	Fur or jewelry purchase	7.0	7.8
$50,000-$99,999	29.4	27.4	Car purchase	80.3	85.8
More than $100,000	12.0	9.4*	Education	86.4	85.5
Memo:					
Number of observations[d]	2,107	3,257			

Source: Board of Governors of the Federal Reserve System, Survey of Consumer Finances.

Notes: Dollar figures are in 1995 dollars. Unless otherwise noted, figures are median amounts, where the median is defined as the midpoint of the distribution. Credit cards are defined as VISA, MasterCard, Optima, and Discover. Asterisks indicate figures that differ from their 1989 values at or below the 5 percent level of significance.

[a] Liquid asset holdings include balances in checking accounts, savings accounts, call accounts at brokerages, certificates of deposit, and mutual funds.

[b] Debt includes debt owed to the family's business and debt held on property that is owned by the family.

[c] Debt payments exclude credit card payments.

[d] Observations are weighted to reflect the U.S. population as a whole.

riskier, we can infer that risky borrowers are joining the pool.[6]

Cardholding and Borrowing
"More" and "higher" summarize the changes in cardholding and borrowing patterns between 1989 and 1995: more cards, higher limits, more borrowing. More than 66 percent of all households had a credit card in 1995, up from 56 percent in 1989 (Table 1). Two is still the median number of cards per household, but holding three or even five cards is increasingly common.[7] Credit limits are also higher. The median limit available per card increased by $900, or roughly one-third. Cardholders took advantage of the higher limits by borrowing more: the mean balance increased from about $1,100 in 1989 to about $1,700 in 1995.[8]

Personal Characteristics
The safest borrowers are usually presumed to be married homeowners with deep roots in the neighborhood and substantial seniority at work. If these personal characteristics are important, then the new borrowers could be riskier.[9] Only 61.0 percent of cardholders were married in 1995, compared with 66.7 percent in 1989. Fewer cardholders were homeowners in 1995, and cardholders had lived at their current address, whether owned or rented, for a shorter period: median residency at a cardholder's current address declined from nine to six years. Cardholders in 1995 also had less job seniority: the average cardholder in 1995 had worked six months less at his or her job.

Age is another potential determinant of credit risk: older borrowers, all else equal, may be more responsible about paying bills. The median cardholder in 1995 was actually a year older than the corresponding cardholder in 1989, so the new borrowers do not appear riskier by that criterion. What Table 1 does not show, however, is a significant increase in the share of young households carrying credit cards. According to the survey, 45.5 percent of households headed by an eighteen-to-twenty-four-year-old had a card in 1995, compared with just 33.7 percent in 1989.

Income, Assets, and Debt
Lower income households now have greater access to credit cards. The median annual income of cardholders fell $4,700 between 1989 and 1995 as the distribution of cardholders shifted toward those with lower incomes. In 1989, 78 percent of cardholders were middle or upper class (with an annual income of $25,000 or more in 1995 dollars). By 1995, this figure had dropped to 72 percent. The share of lower income cardholders rose accordingly over this period, from 22 percent to 28 percent.

The weaker balance sheets of cardholders in 1995 also suggest higher risk. Holdings of stocks and bonds actually rose on average. However, since half of all cardholders in 1995 held no stocks or bonds, the decline in cardholders' *liquid* assets is more revealing: the median holding fell from $6,468 in 1989 to $4,700 in 1995, a drop of more than 25 percent. As liquidity was falling, indebtedness was rising. The ratio of total debt to income rose from 48 percent to 55 percent over the period. The ratio of debt *payments* to income, which reflects interest on the debt, rose from 12 percent to 17 percent. When borrowers are so heavily indebted, even small drops in income can trigger financial distress.

Occupations
Credit cards are no longer a privilege of white-collar workers. Although executives and managers still made up the largest share of cardholders in 1995, their share had declined 5.7 percentage points from 1989. Conversely, the least skilled blue-collar workers, operators and laborers, increased their presence among cardholders by 5.2 percentage points. Because these workers may be more exposed to wage cuts and layoffs than white-collar workers, they may benefit greatly from increased access to credit. By the same token, greater income variability also means that these workers may be riskier borrowers.

Attitudes
Risk also depends on attitudes, and the new borrowers seem to take a riskier view toward credit. Participants in the Survey of Consumer Finances are asked whether it is "all right for someone like yourself" to borrow for certain purposes.[10] Most cardholders in 1989 said they approved of borrowing to buy a car or to pay for education but they disapproved of buying fur and jewelry or taking a vacation on credit. Only 40 percent of cardholders in 1989 said they approved of borrowing to cover living expenses after a drop in income. By 1995, significantly more cardholders approved of borrowing to take a vacation or to cover living expenses after a cut in income. These more relaxed attitudes help explain why cardholders owe more relative to their income. Moreover, these specific uses of credit may be especially risky because they do not necessarily produce an asset that the lender can claim.[11]

Household Profiles and Delinquency Risk
Overall, the new cardholders *seem* riskier in several ways. They are less likely to be married and more apt to rent. They owe more (relative to income), have less work seniority, and are more likely to work in relatively unskilled blue-collar jobs, where income cuts and layoffs may be more commonplace. Even their attitudes toward credit have become more relaxed—they are willing to borrow more, and to borrow for seemingly riskier purposes.

But do these changes really make today's borrowers riskier? We can answer this question using additional information in the Survey of Consumer Finances. Survey participants are asked if they were late on any payment in the year before the survey.[12] Using their responses, we are able to identify the household characteristics in Table 1 that contribute to delinquency risk. Table 2 reports the change in the probability of delinquency associated with a small change in each characteristic, holding other characteristics constant.[13] A negative value indicates that increases in that variable are associated with decreases in delinquency risk. An asterisk next to a variable indicates that the measured impact is statistically significant and not due to a mere fluke in the sample.

What Determines Delinquency Risk?

A household's debt burden turns out to be a crucial determinant of delinquency risk. Households whose ratio of debt payments to income is 1 percentage point higher than average are about 10 percent more likely to have been delinquent. Large holdings of stocks and bonds reduce the risk of delinquency, but the impact is small and insignificant in the statistical sense. Holdings of liquid assets lower delinquency risk more dramatically, presumably because they are a better buffer against unexpected changes in income. The one curious result is the *positive* relationship observed between income and delinquency risk. Higher income households may simply have more types of debt, so they have more payments to make, or miss.[14]

Delinquency risk also depends on a household's personal characteristics. Younger households are riskier, as are less educated ones. Homeownership and longer residential tenure tend to reduce delinquency risk, although the impact of both variables is essentially zero in the statistical sense. Households with longer job tenure also have lower delinquency risk. The delinquency rate among married households is 2.4 percent lower than it is among single or divorced households.

Occupation also affects the probability of delinquency. Operators and laborers, who now account for a larger share of cardholders, have significantly higher delinquency rates than managers and professionals.[15] The higher delinquency rate of these occupations could reflect the fact that operators and laborers work in some of the most cyclical sectors of the economy, such as housing, so their income is likely to be very responsive to the business cycle. Indeed, we found that the difference between delinquency rates for executives and blue-collar workers is significantly larger in more indebted households, exactly what we would expect to find if the difference in delinquency rates reflected differences in income variability.[16]

Table 2
Which Household Characteristics Affect Delinquency Risk?

Variable	Change
Income, assets, and debt	
Debt payments as a percentage of income	9.93*
Total debt as a percentage of income	0.51
Stocks and bonds ($100,000 units)	-0.21
Liquid assets ($100,000 units)	-6.00*
Income (log units)	2.36*
Personal characteristics	
Age	-0.23*
Years of education	-0.61*
Homeowner	-0.78
Years at address	-0.01
Years at job	-0.27*
Self-employed	0.91
Married	-2.38*
Occupations (relative to executives/managers)	
Sales/administrative support	1.54
Service	-1.88
Precision production/repair	1.43
Operators/laborers	3.95*
Farmers	-1.21
Attitudes: belief that it is "all right" to borrow for	
Vacation	-1.41
Living expenses when income is cut	2.28*
Fur or jewelry purchase	-1.50
Car purchase	3.72*
Education	0.43

Source: Authors' calculations, based on data from the Board of Governors of the Federal Reserve System, Survey of Consumer Finances.

Notes: The table reports the percentage change in delinquency risk associated with a small change in each variable. The impact of each variable is estimated holding the other variables constant. The impact is derived from a probit regression estimated over all households in the Survey of Consumer Finances in 1989 and 1995 (7,314 observations). The dependent variable of the regression equation indicates whether a household was delinquent on any payment in the year before each survey. The regression also controls for the year of the survey (not reported). Debt burdens are scaled between 0 and 1.

*Statistically significant at or below the 5 percent level.

Which Changes Matter Most?

Since the mix of individuals holding credit cards has changed along several lines, we want to know which changes matter most in explaining the higher risk of charge-offs. A "back-of-the-envelope" calculation is helpful here. By multiplying the change in each characteristic in Table 1 by the impact of that characteristic on delinquency risk from Table 2, we get the total impact of the change in that characteristic on delinquency risk. Although this calculation is too imprecise to gauge the absolute impact of each change, it does give us a sense of each change's *relative* importance.[17]

The higher debt burden among cardholders seems to be foremost in explaining the higher risk of charge-offs. The median debt-payments-to-income ratio among cardholders increased 5 percentage points between 1989 and 1995. Recall from Table 2 that a 1-percentage-point increase in that ratio raises delinquency risk by about 10 percent. Multiplying these figures suggests that the higher debt burden increased delinquency risk by .50 percentage point. The charge-off rate increased about 2.5 percentage points in recent years, implying that the higher debt burden could explain roughly 20 percent (.5/2.5) of the rise in charge-offs.

The occupational shift among cardholders also matters. Operators and laborers held 5.2 percent more credit cards in 1995, and they are about 4.0 percent more likely to be delinquent, implying that this factor could explain as much as 8.0 percent of the rise in charge-offs (.052 x 4/2.5). Although secondary to the higher debt burden, the occupational shift contributed materially to the increased riskiness of borrowers.

Changes in demographics and attitudes seem to be the least important factors in explaining higher risk. Married households are about 2.4 percent less likely to be delinquent, and their share of cardholders declined by 5.7 percent, so increased cardholding by single households could account for about 5.0 percent of the rise in charge-offs. A one-year decline in job tenure increases delinquency risk by only 0.3 percent, and job tenure among cardholders fell by about half a year, so changing job tenure could explain another 6.0 percent. Attitudes may affect charge-offs indirectly, but their direct impact here is small: about 4.0 percent more cardholders are willing to borrow to cover living expenses when income is cut, and households with this attitude are 2.3 percent more likely to be delinquent, so this change in attitude might account for only about 4.0 percent of the rise in charge-offs.

Conclusion

A comparison of the 1989 and 1995 versions of the Survey of Consumer Finances helps us understand the recent increase in credit card charge-offs. The new borrowers owe substantially more relative to income than did their counterparts in the late 1980s, making them vulnerable to even small drops in income and job growth. The strong link we found between debt burdens and delinquency rates suggests that this increase in debt burdens among cardholders is the most important factor behind the recent rise in bad debt.

Also important is the changing occupational mix of cardholders. The new borrowers are more likely to work in relatively unskilled blue-collar occupations, where delinquency rates are higher—perhaps because income in these occupations is more closely tied to the business cycle. Combined with higher debt burdens, increased cardholding by cyclical workers clarifies how a mild economic slowdown in 1995 could trigger a steep rise in bad debt.

Notes

1. Former Federal Reserve Governor Lindsey (1997) used the term "democratization" to describe the wider distribution of credit cards.

2. The Survey of Consumer Finances, conducted every three years by the Board of Governors of the Federal Reserve System, collects information on a cross-section of about 4,000 households representing the U.S. population as a whole. The survey focuses on household wealth and other financial characteristics.

3. This article does not examine whether the wider distribution of credit cards reflects an increased supply of cards, an increased demand for cards, or both. For more on that issue, see Morgan and Toll (1997).

4. The doubling of the federal bankruptcy exemption in 1994 may also have contributed to the rise in charge-offs. However, the change in the federal exemption would have had no effect on bankruptcy rates in states where the exemptions permitted by state law still exceeded the federal exemption.

5. A borrower is a household with at least one general purpose credit card, such as a Visa, MasterCard, Optima, or Discover. We exclude gas and store cards because they are limited-use credit cards. We also exclude American Express cards because they are charge cards, not credit cards. Using the survey sample of roughly 4,000, we "blow up" the statistics to the population equivalents using the weights provided in the survey. The survey includes five observations for each household as a means of imputing missing values. As is common, we use only the first implicate of the data. This will not bias the estimates, but their variance will be somewhat understated (Montalto and Sung 1996).

6. A rise in average risk implies that the marginal borrower has become riskier if we assume that the households that had cards all along have not become riskier.

7. The average and median of a distribution differ when the distribution is skewed. The average of {1,2,6} is 3; the median (*midpoint*) of this distribution is 2.

8. The mean balance reflects the amount owed after a cardholder's most recent payment. The much lower median balance (that is, the midpoint) reflects households that carry a zero balance.

9. Married households with two sources of income may be better diversified; homeowners may be more stable financially and less likely to move to flee creditors; workers with greater seniority may face a lower risk of layoff. Note that even if the changes in personal characteristics between 1989 and 1995 reflected changes in the population as a whole, we would still conclude that cardholders were becoming riskier.

10. "All right" means different things to different people, but those differences will tend to cancel out across categories.

11. Education loans do, however, produce *human* capital, income from which can be garnished.

12. Since the question is not about credit cards in particular, we cannot be completely precise. Nevertheless, characteristics associated with general delinquency should be correlated with credit card delinquency and, later on, with charge-offs.

13. We estimated the equation $delinquent_i = \alpha + \beta^* profile_i + \varepsilon_i$, where $delinquent_i$ indicates if household i was delinquent on any payment in the year before the survey and $profile_i$ includes the full list of characteristics in Table 1, plus dummy variables indicating the year. We estimated the equation over all households in 1989 and 1995; by excluding noncardholders, we would have raised selection issues and wasted information about the link between risk and household characteristics. With the exception of a few characteristics that did not change much in the first place (age, marital status, and tenure at job and residence), the coefficients were stable across both years. Our equation predicts reasonably well; the actual delinquency rate averaged 16.5 percent in both years, and our equation, evaluated at the mean of each variable, predicted a 13.0 percent rate.

14. Consistent with that reasoning, we found that the positive income effect disappears when we estimate the regression for cardholders only.

15. Note that we are comparing people in different occupations who earned the same level of income, so the difference in delinquency rates probably reflects the fact that income in some occupations is more variable. Income in the services sector is relatively stable, for example, because services, unlike goods, cannot be stored; people continue to pay for haircuts, insurance, and other services during a downturn, but they can cut their purchases of goods by consuming their previous purchases more slowly.

16. We added interaction terms to our regression equation: occupation*debt payments/income. The coefficient on operators/laborers*debt payments/income was 13.2 percent and was significant below the 5 percent level. None of the other interaction terms was significant. Farber (1997) reports that the probability of job loss averaged 14.8 percent among blue-collar workers between 1989 and 1995, compared with only 8.9 percent for executives and managers.

17. Because all delinquencies do not wind up as charge-offs, this calculation gives the *maximum* potential impact on charge-offs.

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About the Authors

Sandra E. Black and Donald P. Morgan are economists in the Banking Studies Function of the Research and Market Analysis Group.

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A SELF-CORRECTING "CRISIS": THE STATUS OF PERSONAL BANKRUPTCY IN 1999

BY LAWRENCE M. AUSUBEL, PROFESSOR OF ECONOMICS, UNIVERSITY OF MARYLAND
(ON SABBATICAL AT UNIVERSITY COLLEGE LONDON)
MARCH 10, 1999

EXECUTIVE SUMMARY

Alarmed by the "bankruptcy crisis"—the explosion in personal bankruptcy filings in the 1995–97 period—the 105th Congress came close to enacting a harsh bankruptcy bill, but ultimately enacted nothing. This brief report assesses the state of personal bankruptcy as of March 1999, concluding that despite the inaction of Congress, the crisis ended by itself in 1998. The personal bankruptcy filing rate per thousand population grew at an annual rate of only 1.5% in the last year, and at a (seasonally-adjusted) annual rate of only 1.0% in the last quarter. Delinquency and chargeoff rates on credit cards peaked over a year ago and are now flat or improving. The economic reason for this precipitous improvement appears to simply be that the bankruptcy crisis is self-correcting: profit-maximizing lenders respond to an unexpected increase in personal bankruptcies by curtailing new lending to the consumers teetering closest to bankruptcy. Thus, the legislative changed reintroduced in the 106th Congress should be viewed as alarmist and unnecessary.

BACKGROUND

During the period of 1995–97, the United States witnessed a sharp explosion in the rate of personal bankruptcies. In the final quarter of 1997, the (seasonally-adjusted) quarterly personal bankruptcy rate stood at 1.287 per thousand population, up 72.2% from the rate only three years earlier. [See the Table at the end of this Report.] Sharp jumps also occurred in other measures of consumer default, such as delinquencies and chargeoffs on MasterCard and Visa cards. The increase in bankruptcies provoked considerable alarm, especially as it occurred during a period of relative economic prosperity.

Legislators concerned with the "bankruptcy crisis"—at the urging of lobbyists for lender organizations concerned with their profits—introduced bills into the 105th Congress proposing broad restrictions on consumer bankruptcy protection. Their proposal, self-styled as "needs-based bankruptcy," was incorporated into several bills, including H.R. 2500, H.R. 3150, and S. 1301. The "Bankruptcy Reform Act of 1999," recently introduced as H.R. 833 in the 106th Congress, incorporates similar restrictions. The harsh proposal would have the effect of forcing many debtors, who are currently eligible for Chapter 7 bankruptcy filings, instead into Chapter 13 filings.

THE RECENT DATA

This brief report relies exclusively on U.S. government data, as seasonally adjusted by the author. For the number of personal bankruptcy filings, I use the quarterly statistical releases of the Administrative Office of the U.S. Courts (*http://www.uscourts.gov/Press–Releases/CY98BK.pdf*). For U.S. population, I use the estimates (for the first day of the middle month of each quarter) of the U.S. Census Bureau (*http://www.census.gov/population/estimates/nation/infile1-1.txt*). The quarterly personal bankruptcy filing rate per thousand population is merely the number of personal bankruptcy filings divided by the U.S. population in thousands, seasonally adjusted. The unadjusted number of personal bankruptcy filings, the seasonally-adjusted number of personal bankruptcy filings, the seasonally-adjusted quarterly personal bankruptcy rate per thousand population, and the annualized growth rate in the seasonally-adjusted quarterly personal bankruptcy rate per thousand population are reported in the Table at the end of this Report. The annualized growth rate of the seasonally-adjusted quarterly personal bankruptcy rate per thousand population is also plotted in the Figure at the end of this Report.

As can be seen from the Table and Figure, the "bankruptcy crisis" began in the First Quarter of 1995, as the (seasonally-adjusted) quarterly personal bankruptcy rate per thousand population—which had broadly been in decline since 1992—began to accelerate at a 12% annual rate. The crisis peaked from Fourth Quarter 1995 to Third Quarter 1996, when the bankruptcy rate increased at a 30% annual rate for a full year. It then began a pronounced deceleration following the Second Quarter of 1997, as the growth declined to less than a 4% annual rate. Today, there looks to no longer be a crisis: the personal bankruptcy filing rate per thousand populations has grown at an annual rate of only 1.5% in the past year, and at a (seasonally-adjusted) rate of only 1.0% in the past quarter.

Similar trends are apparent in the delinquency and chargeoff rates on credit card lending. Both appear to have peaked over a year ago and are now flat or in decline.

It is also worth recognizing that, while the current bankruptcy rate today stands 75% above where it stood four years ago (at the start of the "bankruptcy crisis"), it stands a less-shocking 41% above where it stood seven years ago. The smaller increase over the longer time comes from comparing the current bankruptcy rate with its previous cyclical peak (First Quarter 1992) versus its previous cyclical trough (Second or Fourth Quarters 1994).

ECONOMIC ANALYSIS

Generally speaking, the long-term increase in the personal bankruptcy rate over time appears to have arisen from a long-term increase in the household debt burden. There has been a close statistical connection between the bankruptcy rate and the debt burden, and it only stands to reason that more debt leads to more bankruptcies.

More specifically, the severe nature of the "bankruptcy crisis" of 1995–97 appears to have arisen from an unfortunate combination of a sharp increase in the household debt burden beginning in 1993 and a misappreciation, by some lenders, of the importance of debt burden in predicting the probability of bankruptcy. With 20–20 hindsight, one can today say that consumers with heightened debt-to-income ratios often have dramatically higher incidence of default and bankruptcy. However, the magnitude of this effect was less apparent earlier in the 1990's. In the period beginning 1993, some lenders went about extending large amounts of additional credit to consumers who were already significantly borrowed up, unaware of the extent to which these consumers were rapidly becoming major default risks. These lenders then appear to have been genuinely surprised by the upward spike in defaults and bankruptcies in 1995–97. This aspect of the "bankruptcy crisis" is unlikely to be repeated, as these lenders have now updated their lending formulas to reflect the importance of debt burden in predicting default.

Indeed, the "bankruptcy crisis" is self-correcting. Lenders choose the amount of credit that they are willing to extend, and the riskiness of the consumers to whom they are willing to lend. In turn, the willingness of lenders to tolerate default risk is determined by the profitability of lending. For example, in the current lending environment, a typical credit-card interest rate is 15.7%, while the cost of funds is only about 5°%. This rather large interest-rate spread makes it profitable for issuers to extend credit to consumers with rather high probabilities of default.

But observe that this economic story does not lead one to expect continuing unmitigated and exponential growth in the rate of bankruptcies. Lenders will only extend credit to the extent that it remains profitable. The high rates of default at the peak of the bankruptcy crisis began to impinge on the profitability of lending and—as a consequence—lenders tightened their underwriting standards. This is what made the "bankruptcy crisis" self-correcting.

By the same token, one should not expect that a harsh revision of the bankruptcy law—as in H.R. 833—will lead to a sharp reduction in the bankruptcy rate. As we have already said, lenders determine the level of default risk they are willing to tolerate according to the expected profitability of lending. A tightening of the bankruptcy law will be viewed by lenders as improving the probability that they are able to collect on risky account, i.e., it will increase the expected profitability of lending. As a consequence, lenders will extend credit to inherently riskier consumers than they do today, lending to reverse any potential improvement in the bankruptcy rate.

For a fuller discussion of the economic issues, see the prior article s and testimony of the author:

"The Failure of Competition in the Credit Card Market," *American Economic Review*, Vol. 81, No. 1, March 1991, pp. 50–81.

"Credit Card Defaults, Credit Card Profits, and Bankruptcy" *American Bankruptcy Law Journal*, Vol. 71, Spring 1997, pp. 249–270.

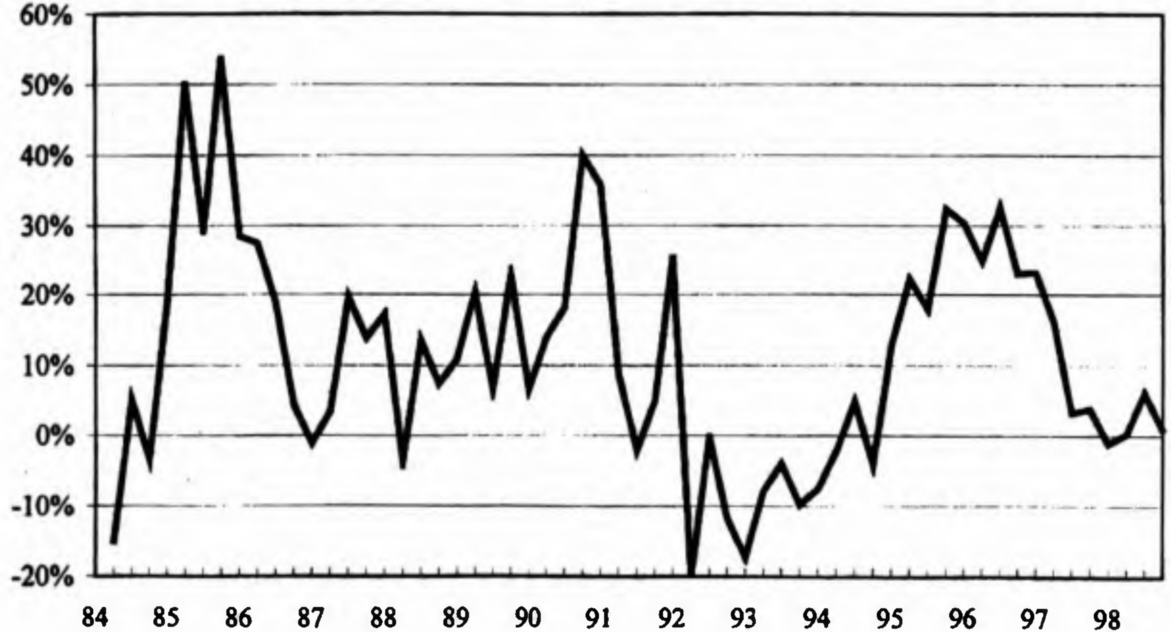
Testimony before the Subcommittee on Financial Institutions and Regulatory Relief of the Committee on Banking, Housing, and Urban Affairs of the United States Senate, Hearing on Bankruptcy Reform, Wednesday, February 11, 1998.

Testimony before the Subcommittee on Commercial and Administrative Law of the Committee on the Judiciary of the United States House of Representatives, Hearing on Consumer Bankruptcy Issues, Tuesday, March 10, 1998.

Year	Quarter Ending	Bankruptcies Unadjusted	Bankruptcies Seasonally Adjusted	Bankruptcies Per 1,000 Population, Seas. Adjust.	Growth Rate From Prev. Quarter, Annualized
1984	March	71,697	72,799	0.3097	
	June	71,955	70,036	0.2974	-15.05%
	September	71,201	71,061	0.3011	5.11%
	December	69,554	70,607	0.2985	-3.42%
1985	March	72,887	73,909	0.3117	18.96%
	June	84,243	82,018	0.3452	50.38%
	September	87,727	87,636	0.3680	29.18%
	December	96,376	97,842	0.4099	53.89%
1986	March	103,088	104,421	0.4364	28.48%
	June	114,384	111,205	0.4637	27.51%
	September	116,037	116,355	0.4841	18.80%
	December	116,204	117,879	0.4894	4.39%
1987	March	116,578	117,827	0.4880	-1.09%
	June	122,689	119,087	0.4922	3.41%
	September	123,868	124,812	0.5147	19.64%
	December	127,409	129,218	0.5317	13.83%
1988	March	133,712	134,769	0.5532	17.21%
	June	138,245	133,804	0.5480	-3.67%
	September	136,561	138,435	0.5657	13.55%
	December	139,215	141,265	0.5759	7.40%
1989	March	144,711	145,317	0.5910	10.90%
	June	157,955	152,541	0.6190	20.31%
	September	152,696	155,432	0.6292	6.77%
	December	161,404	164,027	0.6622	22.72%
1990	March	166,694	167,139	0.6730	6.69%
	June	179,943	173,179	0.6954	13.97%
	September	177,351	180,976	0.7249	18.07%
	December	193,872	197,349	0.7885	39.98%
1991	March	212,913	213,572	0.8512	35.82%
	June	227,853	218,737	0.8694	8.81%
	September	214,174	218,287	0.8650	-2.00%
	December	217,160	221,641	0.8757	5.04%

Year	Quarter Ending	Bankruptcies Unadjusted	Bankruptcies Seasonally Adjusted	Bankruptcies Per 1,000 Population, Seas. Adjust.	Growth Rate From Prev. Quarter, Annualized
1992	March	233,973	235,137	0.9264	25.26%
	June	232,657	222,938	0.8758	-20.11%
	September	220,021	223,462	0.8754	-0.18%
	December	212,112	217,176	0.8484	-11.79%
1993	March	206,271	207,701	0.8091	-17.28%
	June	212,982	203,999	0.7927	-7.87%
	September	200,329	202,473	0.7848	-3.92%
	December	192,617	197,807	0.7648	-9.81%
1994	March	192,707	194,500	0.7502	-7.45%
	June	202,596	193,905	0.7460	-2.18%
	September	195,308	196,701	0.7551	4.93%
	December	189,695	195,187	0.7475	-3.95%
1995	March	199,503	201,669	0.7704	12.82%
	June	222,086	212,528	0.8100	22.20%
	September	220,945	221,980	0.8441	17.93%
	December	231,603	238,673	0.9055	32.42%
1996	March	252,761	255,628	0.9676	30.39%
	June	283,170	270,862	1.0229	24.91%
	September	290,111	291,360	1.0977	32.62%
	December	298,244	307,521	1.1559	22.97%
1997	March	321,242	324,748	1.2178	23.18%
	June	353,177	337,927	1.2643	16.19%
	September	340,059	341,474	1.2747	3.31%
	December	335,032	345,488	1.2869	3.89%
1998	March	341,708	345,354	1.2834	-1.10%
	June	361,908	346,344	1.2842	0.28%
	September	350,859	352,328	1.3036	6.16%
	December	343,220	353,886	1.3068	1.00%

Growth Rate in Personal Bankruptcy Filings
per Capita, Seasonally Adjusted, 1984-98



Mr. NADLER. Mr. Chairman, also, I am somewhat disturbed that we have scheduled three days of hearings in 1 week, and a markup the following week. It seems that if we are seriously intending to take into account the legislation what we hear today, that speed is a little prohibitive.

Finally, and far more seriously, Mr. Chairman, I wish to make what our prosecutors would call a missing witness charge. For more than a year, Mr. Kim Kowalewski of the Congressional Budget Office, has been studying some of the fundamental economic issues which go to the very heart of our ability to understand what is causing the record number of bankruptcies. His work is widely respected in the field. In fact, he was even asked to provide assistance to the National Bankruptcy Review Commission.

We have been unable to get any results from his work. We have been unable to get CBO to allow him to testify at these hearings, despite a request from you, sir, the chairman. His work is continuously sent outside CBO for peer review. The scope of his work has been expanded by CBO leadership well beyond the inquiries put forward by the members of this committee. And this work which results from the request I made a year ago in January, we are told will be completed after the markup next week.

Who does CBO work for anyway? Why is this work, which is going to be released in a few weeks and which bears directly on this matter before the committee, being suppressed until after the markup?

Mr. Chairman, I know that you have requested that Mr. Kowalewski testify. If there is some reason why he cannot be permitted to inform the committee of his more than 1 year of work, then I would ask that you join the minority in making a bipartisan request that CBO Director Dan Crippen come before this subcommittee this week during this hearing and explain himself, and his agency and why they are hiding this witness and this information.

We need information, I believe the American people have a right to this information, and CBO has no business suppressing it.

So, in conclusion, I ask that you, Mr. Chairman, join us in making the request that if Mr. Kowalewski cannot come before us and testify this week for some reason, that Mr. Crippen, the head of CBO, come before us and tell us why he is not permitting the testimony and the research to come before us in this hearing.

Thank you, Mr. Chairman.

Mr. GEKAS. The gentleman's time has expired.

We note the presence of the gentleman from New York, Mr. LaFalce, who wishes to testify as part of the members' presentation, as well as the gentleman from New Jersey, Mr. Rothman. You are invited to take a place at the witness table, and we will permit a 5-minute presentation. Your written statement will become a part of the record.

Mr. CHABOT. Mr. Chairman?

Mr. GEKAS. The gentleman from Ohio is recognized.

Mr. CHABOT. If I could just have one moment. I don't want to make a lengthy opening statement, having already made some opening statements, but I just wanted to, again, commend the chairman for holding this hearing, and rather than the criticism that he has received from some of my colleagues on the other side for moving forward relatively expeditiously, I think we should heap praise on the chairman for actually moving this important issue forward.

Mr. GEKAS. Which I accept.

Mr. CHABOT. I thought you might accept that. We are dealing with an awful lot of important issues in this Congress; saving Social Security, trying to give the American people some tax relief, decide what we do with the so-called surplus, which I think we shouldn't spend. But one of the most important issues we are dealing with in this Congress, quite frankly, is reforming bankruptcy because it is heaping on the shoulders of the American people what, in effect, is a tax of $550 a year in higher prices because of the abuse of the bankruptcy system.

So I compliment you for moving this forward expeditiously and look forward to listening to the panel members today.

Mr. GEKAS. We thank the gentleman.

Mr. LaFalce is recognized. He is a member of the Banking Committee, and for a generation he has been part of the ongoing debate on bankruptcy and bankruptcy reform, and we welcome his commentary.

STATEMENT OF HON. JOHN LaFALCE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Mr. LAFALCE. Thank you very much, Mr. Chairman, Mr. Nadler, gentlemen. I ask unanimous consent to put the entirety of my statement in the record.

Mr. GEKAS. Without objection.

Mr. LAFALCE. Thank you. Mr. Chairman, you are holding hearings on a very important issue, bankruptcy reform. I don't think that we can deal intelligently and fairly with the issue of bankruptcy reform unless we also deal with the difficulties posed by the practices of credit card issuers. And so I would strongly exhort you to have hearings devoted exclusively to that issue. I am not saying only have hearings on that issue, but do have a set of hearings dealing with the practices of credit card companies in an attempt to examine the extent to which the bankruptcy problems are being caused by the credit card companies themselves.

Mr. GEKAS. If the gentleman would yield for a moment. It is ironic that you would state that concern when we stated early last Congress and were informed, by various means, that the Banking Committee would consider it a stomping on their feet if we delved into those issues that are reserved for the Banking Committee. And so I want you to know that it is not out of fear or trepidation or wantonness that we have not——

Mr. LAFALCE. As long as you want to, and I want to, I take that as a statement that you will have hearings on the issue.

Mr. GEKAS. What I am saying to you is that, insofar as the Banking Committee is willing to send to us conclusions drawn from hearings that it would hold on the concerns that you articulate, we will be glad to accommodate. I simply want to state——

Mr. LAFALCE. You are 100 percent correct that the Banking Committee should be having hearings on it, and I have been exhorting the chairman to do that. I am simply saying, though, that it is certainly appropriate for the Judiciary Committee, as part of its hearings on the problems of bankruptcy to have a hearing on that issue.

I also say this: The Senate bankruptcy bill did include a component on the practices of credit card companies.

Now, I have introduced a bill, which I would like to include as a component of any House bankruptcy bill that might move. Rather than go into the specific provisions of the bill that I have introduced at this time, which, in considerable part, borrows from the actions taken by the Senate in the last Congress, let me simply pose a number of questions that I hope that your subcommittee and committee would be asking all those individuals proposing rather serious changes in the bankruptcy laws.

And here are some of the questions, Mr. Chairman:

Why has the credit card industry increased its solicitations amongst known debtors, students and others that it knows have a limited ability to repay debt?

Why does it continue to send out misleading teaser rate promotions that attempt to lure consumers with promises of low interest rates, while often hiding the permanent interest rate and potential penalties that can readily raise interest rates to 25 percent or more?

Why are credit card issuers reimposing annual fees, charging new fees or canceling the accounts of cardholders who routinely pay off their monthly card balances on time?

Why do they continually entice cardholders to add to their debt burdens through the use of third-party convenience checks while not disclosing or not adequately disclosing the additional fees and higher interest charges that often apply to those checks?

Why are issuers sending unsolicited credit cards by mail, often in violation of current law, disguised as telephone calling cards or other consumer benefit cards?

Why are some card issuers imposing fees of $29 on consumers whose payments, sometimes for $5 or $10, are received 1 or 2 days late, while also shortening payment periods and making it harder for consumers to find payment due dates in monthly bills?

Why are issuers now requiring minimum monthly payments that are smaller than monthly finance charges in order to discourage repayment of debt and to add to debt burdens, even when no purchases are made?

Why are many companies also imposing inactivity fees, again as high as $29 a month, on account holders who choose not to use their cards while trying to pay off their debt?

Mr. Chairman, these are only a few of the practices employed by too many credit card companies to entrap consumers into escalating debt, to add unnecessarily to credit cost and discourage responsible credit card use. The practices are unfair, they are costly to consumers, and in many instances, they simply should not be allowed to continue, much less be adequately disclosed.

The bill that I have introduced, H.R. 900, would limit many of the most egregious and unjustifiable practices of credit card issuers. And I would encourage you to pursue this issue and to be open to any bill that the Banking Committee might report or to be open to an amendment that could be brought to the bankruptcy bill at an appropriate time, whenever that appropriate time is before the Rules Committee—or whether permitted by the Rules Committee as a floor amendment.

I would love to offer it jointly with you and Mr. Nadler, Mr. Chairman.

Mr. GEKAS. We thank the gentleman, and we thank him for his offer. We want him to know that, as currently constructed, our current bill does include some of the answers to the concerns that you have raised, perhaps not all of them to your satisfaction and to others', but we have not failed to address those problems, and we will continue to address them as we move on toward markup.

We thank the gentleman for his remarks.

The gentleman from New Jersey, Mr. Rothman, is recognized for 5 minutes.

STATEMENT OF HON. STEVEN ROTHMAN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW JERSEY

Mr. ROTHMAN. Thank you, Mr. Chairman.

Mr. GEKAS. His written statement will become a part of the record.

Mr. ROTHMAN. Thank you kindly. My colleagues, it is good to be with you again, as always.

Let me set forth what I believe are some basic principles in considering the issue of bankruptcy reform. The first principle is that people who borrow other people's money should repay it if they can.

Second principle is that in circumstances where people who borrow other people's money are not able to repay in full, and if after consideration of reasonable and necessary expenses they are still able to pay a portion of the money they borrowed from someone else, they should pay that portion they can afford to pay. But if they cannot pay any of it, they should be excused from their debts entirely and be given a fresh start.

Those are the principles that guide me in the consideration of the discussion of bankruptcy and bankruptcy reform. I am here to say that I support the Gekas bill because I believe that it is a reasonable step toward eliminating the worst abuses of the bankruptcy system, yet preserves the majority of the benefits that the bankruptcy system was supposed to provide.

As I understand it, today, 70 percent of people who file for bankruptcy are placed in Chapter 7 and 30 percent are placed in Chapter 13. If the Gekas bill were to become law, that number would change as follows: Not 70 percent, but 63 percent of the filers would still be in Chapter 7 and 37 percent would then be in Chapter 13. I am told that this bill would affect, at the most, only 10 percent of Chapter 7 filers. Ninety percent of those filing for Chapter 7 would not be affected at all, and the 10 percent would merely face the presumption.

The bill also makes some other beneficial changes, not just holding those who would abuse the system accountable for the portion of the debts they can afford to repay, but it also moves alimony and child support from seventh to first priority, closing a loophole in that bankruptcy system that debtors can use to avoid or delay these payments.

There is a debtors bill of rights, there is prohibition against credit card company penalties, there are enhanced disclosures, there is consumer education, there are alternative dispute resolutions required, and there are studies authorized by the Gekas bill. I believe it is a bill worth supporting.

I just want to mention in my previous life I was a lawyer, a mayor of a small city of 25,000, and a surrogate court judge for a county of almost a million people. I worked in a mom-and-pop kind of a neighborhood law practice, and many of my clients were working people, or less than working class people in an economic sense, and they literally went from big job to big job. And if those who hired them for the big jobs stiffed them on payment after their work, they suffered grievously or went out of business. I cannot tell you the dozens of times these folks would come to me and ask me, "Steve, how could they let this happen? I did the work. My people did a good job. And the guy who hired me said, 'I'm going to go bankrupt again. Take 50 cents on the dollar for your work.'"

This bankruptcy reform issue may also be seen as part of our effort in the United States to reinstill a sense of personal responsibility. Part of that was apparent in the welfare reform laws, part of that in making cigarette manufacturers responsible for the poisons they have caused people to become addicted to, and laws making polluters pay and others.

There will be those who will resist this move toward more personal responsibility, but I believe that the rest of society who has to pay for these abuses should not have to pay, and that is why I support this very reasonable bankruptcy reform bill. I thank the Chair for allowing me to make my presentation.

Mr. GEKAS. We thank the gentleman for his remarks, and we look forward to further cooperation at the full committee when we determine the final text of the bill to be presented to the full committee. We thank the gentleman.

Does the gentleman from Virginia wish to make a statement or is he auditing this hearing? [Laughter.]

Mr. GEKAS. The gentleman from Virginia, Mr. Moran, is recognized for any remarks he wishes to render.

STATEMENT OF HON. JAMES P. MORAN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF VIRGINIA

Mr. MORAN. Well, thank you, Mr. Chairman. I have been trying to be kind of a presence at these hearings because I really feel that what we have is a reasonable, balanced and should be bipartisan piece of legislation. It is better than last year's bill, and yet last year's bill passed overwhelmingly on the House floor.

This year, we have additional consumer protections. We have basically a bill of rights for consumers. The credit card companies are going to have to notify consumers that if they just pay the minimum payment they could be paying until they are buried deep in the ground, and they are only paying on interest costs. That is the kind of information that is important for consumers to be aware of. We are going to try to do away with these mills, really, bankruptcy mills, where people try to exploit others to get them through the bankruptcy system not for the benefit of the consumers, but for their own economic advantage.

There are a number of built-in safeguards here, but the most important is this is income based. If you have an income that is only meeting your daily needs; in other words, less than the median income of about $51,000 for a family of four, then this doesn't really apply to you. You have the choice of either going Chapter 7 or Chapter 13. I think that is very fair.

We are only trying to go after the people who have the means to pay off their debts, but instead of using their financial ability to pay off the debts, are declaring bankruptcy and passing that debt on to other people who do pay their debts. That figure of $400 a year that each American family is having to pay just to make up for the bad debts of others is wrong. That is something we should assume responsibility for, and I would hope that any legislation is going to act in such a way that that $400 burden is going to be relieved because it is just so unfair. It is almost immoral, really, for that kind of bad debt to be passed on by people who can afford to pay off their debts.

And the fact that we have 1.4 million bankruptcies, more than we have college graduates, that does not reflect the prosperity that we are experiencing in the country. It reflects the fact that people are gaming the system.

And so I would hope that we could get a bipartisan bill out of this committee, that we could get the support from both sides of the aisle, that we could get a bill enacted this year. And I know that that bill is going to put as a priority child support, protection of widows and divorced spouses and so on, and single parents, but it is going to go after the people who are really putting a stain on the entire system of bankruptcy. It is not what the bankruptcy system was ever intended to do, and I hope we are going to right it with this legislation and that we can get it passed early. It will set, I think, a very positive, constructive signal that this Congress can get along, that it can work constructively together, and that we can do the right thing for the vast majority of the people of this country.

Mr. GEKAS. We thank the gentleman, and we look forward to further debate on this matter. Thank you.

Mr. MORAN. Thank you, Mr. Chairman.

Mr. GEKAS. The Chair will acknowledge the presence of the gentleman from Arkansas, Mr. Hutchinson. Does he have an opening statement of any type?

Mr. HUTCHINSON. No, Mr. Chairman, I do not. I am here to listen and learn. This is a very helpful hearing that you are having, and a very important piece of legislation, so I look forward to the testimony.

Mr. GEKAS. I thank the gentleman.

I was interested in the criticism hurled this way by the gentleman from New York relative to the content of the article in the National Journal's Congress Daily A.M. in which the gentleman from New York took great delight, it seemed, in pointing out that Gekas' office has made no secret of the fact that it believes the hearings likely will prove to be a mere rehash of issues already discussed last Congress.

Except for the word "rehash," which is sort of pejorative, I think it is fair and productive for us to say that what 60 witnesses produced last term—that is 60 witnesses and several hearings—not counting the hearings and testimony on the Senate side, really covered the entire territory required for us, for the public, and for Members of Congress and for all concerned to learn what is to be learned about the need for bankruptcy reform. And so when we reproduce a bill in this Congress, which for the most part reiterates the work of the previous Congress and carries with it the same body of support, and testimony, and the same criticisms that were foisted and some corrected from the last Congress, then it is proper to say that, indeed, we are allowing a full review, rehash—as the gentleman from New York is probably very happy to use that word. We are reviewing, and restating, and reiterating, and reconstituting, and re-endorsing the work of the last Congress and the statements of those witnesses who will be endorsing and re-endorsing their own statements in these hearings yet to come. I think it is very helpful to re-educate the Members of Congress, to re-educate those who are interested in bankruptcy reform and to reinform the American public that we are intent on proceeding with meaningful reform.

Later, in that same article, again, the gentleman from New York was ecstatic in being able to point out that "these meetings are primarily for the benefit of committee Democrats, like subcommittee ranking member Jerrold Nadler, who are opposed to Gekas' approach."

Of course, we made certain that whatever we can do to get Mr. Nadler and some of his supporters to fully understand the severity of the problem—that the country is sick and tired of bankruptcy, 1,400,000 bankruptcies—per year so that they can have full knowledge about what is going to happen if we continue down this path, to have full exposure to all that we are doing, to have extra meetings, extra witnesses, extra forums. We have had staff briefings, and breakfasts, and luncheons, and memos back and forth ad nauseam to inform the Democrats and the minority, those who oppose bankruptcy reform, so that they should know everything about the subject. I plead guilty. I am proud of pleading guilty that we have taken these extra steps.

And, further, "It will be a restatement for those who claim not to be up to snuff with knowledge." That is exactly correct. Although it sounds awful the way Mr. Nadler reported it and repeated it, and even I was shocked at it when I first heard it from his statement. Now, I read it, and I am parsing—parsing, you understand, is a way of doing things in Washington these days—that it will be a restatement for those who claim not to be up to snuff with knowledge.

If they did not understand the statements of the salient witnesses that produced testimony last year, maybe this year they will understand it. Those who did not understand what happened last year, even if the testimony is repeated this year, might have a better chance to understand what the concerns are.

I think that we are doing a good job. That is what this article is saying. We are doing a good job. We are making sure the Democrats, the minority, know everything we are doing, that we provide staff briefings, that we provide expert testimony on one of the primary issues of which they stated concern last term and this term, spousal support, family support, children, alimony, all of those issues, and, on top of that, we restage hearings in which we give them full blank-check rights to call witnesses of their own—which they must acknowledge. If they don't, then we have another battle on our hands—that their witnesses many times have been called by the majority. And where they have failed to call witnesses who favor their position, we took it upon ourselves to make sure that witnesses favoring their side and opposing our bill would be a part of the witness table at these hearings.

I feel good about it, and I feel great about the criticism. It gave me an extra forum to demonstrate that we, indeed, are going the extra mile to try to help resolve an issue, not oppose bankruptcy reform, but to try to bring a sensible reform to a much-needed arena in our world of commerce and, indeed, in our family life in this country.

[The prepared statement of Mr. Gekas follows:]

PREPARED STATEMENT OF HON. GEORGE W. GEKAS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF PENNSYLVANIA, AND CHAIRMAN, SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW

Today, we commence the second of four hearings that the Subcommittee will hold on the topic of bankruptcy reform and H.R. 833, the Bankruptcy Reform Act of 1999, a bill that I introduced last month.

We begin today's hearing with a Members Panel, where my colleagues will have an opportunity to share with us their thoughts about this bill, which I hope will be largely favorable, if only because of my pride of authorship. But seriously, I want everyone to understand one simple fact: H.R. 833 is *exactly* the same in all respects as the conference report on H.R. 3150, a bill that was overwhelmingly supported by Republicans and Democrats alike, as evidenced by a 300 to 125 vote in the waning days of the last session.

Given that level of support and given the fact that in the last Congress alone we held four days of hearings on H.R. 833's predecessor—during which we heard from *more than 60 witnesses*—some have argued that there is absolutely no need for any additional hearings on H.R. 833. While these arguments are compelling, I have nevertheless insisted that we hold comprehensive and fulsome hearings that fully develop the issues.

Last week's hearing is a perfect example of the value of holding hearings. Among the witnesses who testified, was a bankruptcy judge who had presided over more than 35,000 cases during her tenure on the bench and who was invited, I might add, at the request of my colleague, Mr. Nadler. Without hesitation, this judge said, and I quote, "I agree with Chairman Gekas that people who can pay should pay. I think that is fundamental." And, with regard to the needs-based test, which is the heart of H.R. 833, this judge unequivocally stated, "I predict that [this test] will affect my caseload not one iota."

The statements of this bankruptcy judge clearly underscore the two primary goals of H.R. 833. First, to restore the fundamental concept of personal responsibility in the bankruptcy system by requiring those who have the ability to repay, to do so. And, second, to ensure that only those debtors who have the ability to repay are targeted, while those who lack this ability will receive their "fresh start" forthwith and not be affected by these reforms, to quote the judge again, "one iota."

Today's hearing is no exception. In addition to our colleagues, we will hear from some of the nation's leading bankruptcy experts and academics. The first panel will provide a historical perspective of bankruptcy law and reform that should be most enlightening. Following this panel will be one devoted to the need for consumer bankruptcy reform.

Mr. GEKAS. So, with that, we invite the members of the first panel to come.

I think that the next set of concerns that the gentleman from New York might have will be personally recorded with the chairman——

Mr. NADLER. Mr. Chairman, I have a unanimous consent request. That is all I have.

Mr. GEKAS. I am getting to that. I am getting to that.

Right now, I am simply saying to you, whatever other concerns you might have about scheduling hearings, staff briefings, memos, et cetera, I am willing to meet with you so that you will be even further satisfied that we are trying to do the right thing.

In the meantime, I have a unanimous consent request to allow the testimony of the Honorable Bill McCollum before the House Judiciary Committee's Subcommittee on Commercial and Administrative Law to be entered into the record.

[The prepared statement of Mr. McCollum follows:]

PREPARED STATEMENT OF HON. BILL MCCOLLUM, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF FLORIDA

Mr. Chairman, thank you for providing me with an opportunity to testify on the need for bankruptcy reform as outlined in H.R. 833. I appreciate the time and attention the Chairman has dedicated to this important issue and commend you for holding these hearings.

Two years ago, I introduced H.R. 2500, the Responsible Borrower Protection Bankruptcy Act, as it became clear that reform of the existing bankruptcy system was sorely needed. At the time the bill was introduced, our nation was witnessing an epidemic of personal bankruptcies. From 1986 to 1996, real per capita annual disposable income grew by over 13 percent but personal bankruptcies more than doubled. In 1996, for the first time ever, there were more than 1 million personal bankruptcy filings. In fact, bankruptcies have increased over 400 percent since 1980.

At the time, it was estimated that personal bankruptcies would rise by 20 percent in 1997 to 1.3 million personal bankruptcy filings. In fact, the increase in personal bankruptcy filings in 1997 was even larger than expected, with the Administrative Office of the Courts reporting over 1.4 million personal bankruptcy filings, constituting a 23 percent increase. That is more than one bankruptcy per every 100 American households. Last year, there were again more than 1.4 million filings.

Bankruptcy will cost our nation more than $50 billion in 1998 alone. That translates into over $550 per household in higher costs for goods, services and credit. If we do not make reforms now, responsible borrowers and consumers will continue to pay the price in the form of higher costs for goods, services and credit.

Mr. Chairman, what is most disturbing about this rate of increase is the fact that it is occurring at a time when the nation is experiencing a robust economy with the lowest unemployment rate in more than 20 years. If we do not address personal bankruptcy reform now, while the economy is doing well, the problem will only become worse during a recession.

H.R. 833 fundamentally reforms the existing bankruptcy system into a needs-based system. Only those who truly cannot repay their debts will be able to use the complete bankruptcy in Chapter 7 of the Bankruptcy Code. Those who can repay their debts will have to use Chapter 13 and work out a repayment plan.

Needs-based reform is intended to address a flaw in the current bankruptcy system which encourages people to file for bankruptcy and walk away from their debts, regardless of whether they are able to repay any portion of what they owe, by using the straight bankruptcy of Chapter 7. Under the current bankruptcy system, the vast majority of those who file are not even examined to determine if they are able to repay even a portion of what they owe. Such a misuse of our bankruptcy laws is fundamentally unfair to those who play by the rules and take responsibility for their personal obligations. Needs-based reform would directly address this flaw by requiring that those who have the ability to repay file in Chapter 13 and work out a repayment plan. H.R. 833 outlines a formula for determining ability to repay which takes into account income, debts, and expenses.

Mr. Chairman, our nation's bankruptcy laws play a vital and necessary role in our society. We must ensure that our bankruptcy system does not encourage those who can take responsibility for their debts not to do so. Under the current system, about 70 percent of those who file for personal bankruptcy file in Chapter 7, while only about 30 percent file in Chapter 13.

If Congress fails to fix the flaws in the current bankruptcy system now, then responsible borrowers will continue to pay the price. Mr. Chairman, I am confident that, under your leadership, these three days of hearings will make it clear that adoption of the bankruptcy reforms outlined in H.R. 833 is vital to ensuring that our bankruptcy laws operate fairly, efficiently and free of abuse. I comment the Subcommittee for tackling this important issue and look forward to continuing to work with you in addressing this issue.

Mr. GEKAS. I understand the gentleman from New York has a similar request.

Mr. NADLER. Yes, Mr. Chairman. I stated in my statement I praised the chairman and the majority——

Mr. GEKAS. Which we accept.

Mr. NADLER [continuing]. For holding these hearings, for calling not only the minority witnesses, but a good set of majority witnesses that I think will help elucidate the problem. So I fully agree with the chairman, and I praised him for doing that.

The only reservation I stated was that the scheduling of these hearings, 3 full days of hearings this week with a markup next week, doesn't seem to leave much time between now and next week for whatever comes out of these hearings to be incorporated in a bill.

But in any event, I have a unanimous consent request, Mr. Chairman. Our colleague, the Senator from Illinois, Mr. Durbin, was unable to testimony at last week's joint hearing. He was the ranking senator on the Subcommittee of Jurisdiction, the other body, and I ask unanimous consent that this testimony, which he has submitted in writing, be made part of the record.

Mr. GEKAS. Without objection, it is so ordered.

[The prepared statement of Senator Durbin follows:]

PREPARED STATEMENT OF HON. RICHARD J. DURBIN, A U.S. SENATOR FROM THE STATE OF ILLINOIS

Introduction: I'd like to thank the Senator Grassley and Senator Torricelli, as well as Congressman Gekas and Congressman Nadler, for inviting me to testify today on this important issue. I hope my experience from last year will help you as you begin your deliberations.

- A constant theme that guided me throughout the consideration of bankruptcy legislation was balanced reform. You cannot have meaningful bankruptcy reform without addressing both sides of the problem—irresponsible debtors and irresponsible creditors.
- The bill that passed the Senate last year was a balanced, bi-partisan effort. Senator Grassley and I worked very hard to develop a bill to address abuses by both debtors *and* creditors. Our bill passed the Senate by a vote of 97–1.
- Unfortunately, the bill we worked so hard to develop, was decimated in conference and the result was a one-sided bill designed to reward the credit industry and penalize American consumers. I could not support it. I hope this year will be different.
- In order to discuss serious bankruptcy reforms, we must have a better understanding of the problem.

LATEST STATISTICS:

Last year, was a record year for bankruptcy filings. Almost 1.4 million people filed for personal bankruptcy. This number (1,398,182) represents a 3.5% increase from 1997.

In Illinois: 62,000 people filed for personal bankruptcy in 1997, a 18 percent increase in the 53,000 filed in 1996.

Latest Figures Show: In 1997, all 50 states had record filings.

These figures are disturbing and we want to address abuses but we should not create a nation of financial outlaws

Bankruptcy is the last if not the only social safety net for the middle class

So we need to deal with the problem, but not in radical and draconian ways.

FACTORS CONTRIBUTING TO BANKRUPTCY FILINGS

1. Probably the single biggest cause of bankruptcy filings is credit extended to people who never should have been given credit in the first place.

PERSONAL BANKRUPTCY RISES WITH CONSUMER DEBT:

The rise in personal bankruptcies almost exactly tracks the rise in average consumer debt.

Credit card solicitations: In 1997, the credit card industry sent out 2.4 billion pre-approved credit card applications. There are only about 78 million credit worthy households in the U.S.

Nationwide credit card charges: According to Federal Reserve figures, American consumers racked-up more than $5 billion in revolving debt during January of 1999 alone.

Nationwide outstanding credit card debt: Total credit card debt now stands at approximately $555 billion with $450 billion coming from general purpose cards such as VISA, MasterCard and American Express. (SEE CHART)

Impact on consumers: The result of all this credit can be devastating on an individual. A slight increase in the amount of credit card debt that a person is carrying can make them significantly more likely to declare bankruptcy.

Nationwide credit card interest: In 1996, U.S. consumers paid $65 billion in interest on credit cards.

So in these times, it is even more important for people to be fully informed about and careful with the credit card debt they rack up. That's why this legislation is more important than ever.

WHAT DID LAST YEAR'S SENATE BILL DO?

The key provisions dealt with abusive filings—i.e. people who can still afford to pay but try not to—and abusive serial filings.

Here are the key provisions:

- *Reform of the abusive filings provision*: Allow creditors to assert that a particular bankruptcy is abusive and get it dismissed.
- *Limitation on ability to file multiple bankruptcy petitions*: Under the bill you cannot get 10 bites at the apple.
- *Provided a better way of getting information*: It required that debtors file more comprehensive information with the court—income tax forms, debt schedules, etc.
- *Required timely filing of plans*: Required people to file their plans in a timely manner rather than the current system which has no deadline.
- *Provided for outside auditing of bankruptcy filings*: This would improve our ability to catch fraudulent filings.

The bill also prevented creditor abuses:

Most importantly, the bill was balanced. It addressed abusive creditor practices. For example, if a creditor unjustifiably objected to the discharge of a debt, the creditor would suffer penalties. If the debtor tried to renegotiate their debts, and the creditor refused to bargain in good faith, the court could take it into account.

Very often creditors charge debtors all of the attorneys fees that the creditor racked up in pursuing the debt. That often leaves debtors in bankruptcy owing more. The bill limited the abilities of creditors to do this.

- *Predatory lending provisions*: High-cost home mortgage lenders have been gouging elderly and financially unsophisticated homeowners with low to moderate incomes with a variety of abusive lending practices. Last year's Senate bill prohibited abusive lenders who have preyed on unsophisticated consumers from recovering their claims against homeowners in bankruptcy. Specifically, the provisions prohibited recovery if the mortgage:
  - — failed to comply with disclosure requirement;
  - — contained excessive default interest rates;
  - — required lump sum balloon payments on loans of less than 5 years;
  - — used negative amortization or required prepaid payments paid in advance of loan proceeds;

— was made without regard to the consumer's repayment ability;

— or failed to meet special home improvement loan requirements.

REASONS WHY THE HOUSE BILL WHICH IS VIRTUALLY IDENTICAL TO THE BANKRUPTCY CONFERENCE REPORT IS NOT A GOOD STARTING POINT FOR BANKRUPTCY REFORM

The conference report did *not* provide balanced bankruptcy reform that would curb both creditor and debtor abuse. It watered down or eliminated altogether important provisions we fought to include in the Senate bill.

1. *Needs-based bankruptcy*: The conference report imposed a rigid and arbitrary means test that we thought would send waves of debtors into Chapter 13 repayment plans without regard to whether they could succeed. The test created a presumption based on IRS tax collection standards which a debtor could rebut only on a showing of extraordinary circumstances.

But, we now know that the means test would only apply to 3% of Chapter 7 filings: A study released by the American Bankruptcy Institute found that by using the test from the House bill, 97% of sample Chapter 7 debtors had too little income to repay even 20% of their unsecured debts over five years. As a result only 3% of the sample Chapter 7 filers had sufficient repayment capacity to be barred from Chapter 7 under the rigid means test.

WHY SHOULD WE PASS LEGISLATION THAT WILL ONLY APPLY TO 3% OF THE CASES?

2. *Reaffirmations*: A reaffirmation is a debtor's agreement to continue paying off a debt to a particular creditor despite filing bankruptcy. In other words, a side agreement to continue paying a debt normally forgiven in bankruptcy. For example, people may need to keep their cars to keep their job, so they reaffirm a car debt. Other times, however, people reaffirm debts because they are intimidated by aggressive creditors.

The conference report eliminated provisions that prevented reaffirmation of secured debts for personal property under $250—where creditor abuses like those in the Sears cases have repeatedly occurred. Where unsecured debt is reaffirmed, the court does not consider reaffirmation's effect on the debtor's dependents or the debtor's future ability to pay child support, and has no real power to review coercive creditor behavior in the course of obtaining the agreement.

3. *Penalties for bad creditor behavior*: The conference bill gutted provisions making specific coercive behavior a violation of the automatic stay, dropped penalties for reaffirmation violations from $5,000 to $1,000, rolled back current law that permits a court to award punitive damages to redress stay violations under appropriate circumstances, and also prohibited class actions, which are currently allowed.
4. *Consumer disclosures*: The conference bill stripped the requirement that credit card companies inform consumers on a monthly basis of the consequences of making only the minimum payment on their individual account, and permitted credit card companies to terminate customers who pay in full after a period of inactivity or on the expiration date.
5. *Nondischargeable debt*: The conference report made non-dischargeable (unforgivable) all debts that were not "necessary" to individual creditors incurred 90 days before bankruptcy. It also made all cash advances more than $250 incurred 90 days before bankrupt nondischargeable. These debts will compete directly with alimony and child support in the post-bankruptcy world. The conference also deleted fee-shifting provisions for dischareagability litigation that would have discouraged frivolous litigation and the depletion of funds.
6. *Homestead exemption*: The conference report rejected a uniform cap on homestead for all states in favor of a lengthened residency requirement that would only catch bankruptcy filers who move to Florida or Texas or other states with high homestead exemptions prior to filing bankruptcy.
7. *Predatory lending*: The conference report stripped out the predatory lending provisions, which were designed to protect consumers, particularly elderly homeowners over the age of 65 living alone.

WHY LAST YEAR'S SENATE BILL IS BETTER:

- *It's cheaper*: The House bill basically sets up a federal bureaucracy to ferret out a few extra dollars from debts. But, we now know from the ABI study that the means test will only apply to 3% of the cases and we have to ask ourselves whether it is an efficient use of resources.

- *It's fairer*: Last year's Senate bill is flexible enough to get the big spender and to look closely at the poorer person.
- *It's easier to administer*: Last year's Senate bill uses current bankruptcy procedures. It can be used immediately.

CONCLUSION:

I urge this Committee not to use the so called "conference" bill that failed to gain the support needed to pass, as the starting point for meaningful bankruptcy reform.

Instead, use a more balanced approach to address the abuses without making the so called "reform" worse than the problem. Last year's Senate bill was not perfect, but it was a good start.

Thank you.

Mr. GEKAS. We invite the members of the first panel to approach the witness table.

James I. Shepard was appointed to the National Bankruptcy Review Commission by then Senator Bob Dole, where he served as commissioner from 1995 to 1997. Prior to and following his service with the Commission, Mr. Shepard served as a bankruptcy tax consultant. He is an adjunct professor of law at the McGeorge School of Law in Sacramento, California, and at the San Joaquin College of Law graduate tax program in Fresno, California. Mr. Shepard has practiced law in Colorado, Iowa, and Nebraska. In 1987, Mr. Shepard became associated with a major accounting firm in Fresno, California. He has written and lectured extensively on bankruptcy taxation matters. He obtained his bachelor of arts from the University of Iowa, and thereafter received his juris doctorate and master's of law degrees in taxation from the University of Denver.

He is joined at the witness table by Professor Eric Posner of the University of Chicago School of Law. After receiving his bachelor of arts and master's in philosophy, summa cum laude, from Yale University, he went on to obtain his juris doctorate from Harvard Law School, magna cum laude. His other work experience includes service as a law clerk to the Honorable Stephen F. Williams of the United States of Court Appeals for the District of Columbia. He, thereafter, was an attorney adviser at the Justice Department's Office of Legal Counsel. Before joining the faculty of the University of Chicago's School of Law, Professor Posner was an assistant professor at the University of Pennsylvania Law School from 1993 to 1998. His recent publications include articles in the economics and history of bankruptcy law, the economic theory of contract law and international law.

With these first two gentlemen is Professor David Skeel, professor of law at the University of Pennsylvania Law School. Prior to joining the faculty at that institution, he was an assistant professor of law at Temple University from 1990 to 1998.

Professor Skeel received his law degree from the University of Virginia School of Law, where he was an editor of the Virginia Law Review and a member of the Order of the Coif. He, thereafter, clerked for the Honorable Walter Stapleton of the United States Court of Appeals for the Third Circuit.

Professor King is with us, the Charles Seligson Professor of Law at New York University School of Law. He is also counsel with the New York law firm of Wachtell, Lipton, Rosen and Katz. After receiving his bachelor's degree from the City College of New York in

1950, he obtained his law degree from New York University in 1953, and his master's of law degree from the University of Michigan in 1957. Professor King served on the Advisory Committee on Bankruptcy Rules of the Judicial Conference of the United States from 1983 to 1992. He was the reporter for the committee from 1979 to 1983. Prior to that, he served as the associate reporter for the committee from 1968 to 1976. Professor King was a consultant with the Commission on the Bankruptcy Laws of the United States from 1972 to 1973, and he was a senior adviser to the National Bankruptcy Review Commission from 1996 to 1997. Professor King is editor-in-chief of Collier on Bankruptcy, a leading bankruptcy treatise. In addition, he is co-editor and chief of Collier Bankruptcy Practice Guide.

Ralph Mabey received his law degree from Columbia University in 1972, where he served on the Board of Editors of the Columbia Law Review. Thereafter, he was a United States Bankruptcy Judge for the District of Utah from 1979 to 1983. Currently, Mr. Mabey leads the corporate restructuring and reorganization practice of LeBoeuf, Lamb, Greene and MacRae, where he has served as counsel in several multi-billion cases, including Baldwin United, Columbia Gas System, Federated Department Stores and TWA. From 1987 to 1993, Mr. Mabey served as an appointee of the Chief Justice to the United States Judicial Conference's Advisory Committee on the Bankruptcy Rules. He has also served as the managing editor of the Norton Bankruptcy Law Adviser and on the editorial board of the American Bankruptcy Law Journal. He currently is a contributing author to Collier on Bankruptcy and the Collier Bankruptcy Manual.

Judge Joe Lee is a United States Bankruptcy Judge for the Eastern District of Kentucky. Before assuming the bench in 1961, Judge Lee served in the United States Air Force from 1943 to 1949, where he was a member of the Eighth Air Force Division in England during World War II. After obtaining his law degree from the University of Kentucky, Judge Lee clerked for the Honorable James Milliken, Chief Justice of the Kentucky Court of Appeals and for the United States District Judge Hiram Church Ford. He was also counsel for a congressional subcommittee in the U.S. House of Representatives. In addition to receiving numerous awards for his distinguished judicial service and other accomplishments, Judge Lee served as editor-in-chief of the American Bankruptcy Law Journal from 1982 to 1990.

Leon Forman has concentrated, for about 60 years, on various points of law practice; on bankruptcy, reorganizations, workouts and other banking and commercial lending matters, including loan restructurings, debtor-in-possession financing, and lender liability. He received his juris doctorate degree from the University of Pennsylvania Law School, where he was a member of the Board of Editors of the Law Review. A partner with the Philadelphia law firm of Blank, Rome, Comisky and McCauley, Mr. Forman was previously associated with Wexler, Weisman, Forman and Shapiro, which later merged with his current firm. Mr. Forman is a member of numerous professional organizations, including the American College of Bankruptcy, where he serves as scholar in residence. He is also a member of the National Bankruptcy Conference, the

American Law Institute and the Commercial Law League of America.

With that introduction, we will inform the members of the panel, as we will continuously, that their written statements will form a part of the record without objection, and they will each be allotted 5 minutes for a review of that written statement.

Mr. Shepard will begin.

STATEMENT OF JAMES I. SHEPARD, ESQUIRE, BANKRUPTCY TAX CONSULTANT, FORMER MEMBER OF THE NATIONAL BANKRUPTCY REVIEW COMMISSION, FRESNO, CA

Mr. SHEPARD. Thank you, Mr. Chairman. It is an honor to be invited to appear before this subcommittee today. My comments today are based on some of my observations regarding my service on the National Bankruptcy Review Commission, its process and the need for bankruptcy reform.

The 2 years of serving on the Commission, where hearings were held nationwide and presentations made by debtors, lawyers, creditors' lawyers, bankruptcy judges and representatives of numerous organizations, easily leads one to the conclusion that bankruptcy has grown too important to entrust to those who work within the bankruptcy industry. The drafting of bankruptcy laws should not be left to those who have a vested interest in the implementation of those laws, whether creditors, debtors, lawyers or judges.

First of all, bankruptcy is a big business. If the debtors' lawyers who filed the more than 44,000 business cases in 1998 received an average of $30,000 in fees, a conservative estimate, that group received a total of over $1.3 billion. If the consumer debtors' lawyers received an average of $1,000 for each of their 1.4 million cases, that group received nearly $1.4 billion. That means that the debtors' lawyers were paid approximately $2.7 billion for filing the cases in 1998. Assuming that the creditors' lawyers were paid just half of that amount and adding in the rest of the rest of the participants in the system, bankruptcy is easily a $5 billion-a-year industry at the expense of the American public, and these figures don't include the cost of the judicial system, the cost of administering the cases or the debt that was discharged.

So what is the proper role of the bankruptcy law and the courts? Bankruptcy judges should be discouraged from rendering result-oriented decisions, those where the Bankruptcy Code lacks clarity and allows the court to read it in a manner never contemplated by Congress. Such judicial legislation creates law that was not intended and invades the province of Congress. Inconsistent and illogical application of law creates an attitude of disrespect for the law, particularly where it creates special benefits for those who don't deserve it.

The public's perception of fairness and equality of law is an asset which must be protected and not jeopardized by permitting debtors to use bankruptcy as a means of improperly avoiding their obligations. Thus, where bankruptcy becomes too appealing and causes people to be less responsible, the law must be changed.

And where the cost of bankruptcy to the public, whether in increased interest rates, increased restrictions on credit, increased cost of goods or increased costs of Government become excessive, the law must be changed. One county property tax assessor said to me, "Just tell me how much bankruptcy will cost, and we can adjust the rates to make up the difference." Well, how did we get here?

During the 2-plus years of its existence, the prior Commission, the Commission on the Bankruptcy Laws of the United States was charged with rewriting our bankruptcy laws, a collection of outdated, sometimes unworkable and frequently undesirable laws, which had served the country for 90 years without a major change since the promulgation of consumer bankruptcy laws in the Chandler Act of 1938.

The present Commission, the National Bankruptcy Review Commission, on which I served, was given a more narrow charge, determining the problems with the Code and suggesting changes for improvement. The prior Commission held only four public hearings and conducted their discussions mostly in executive session. The present Commission conducted nearly all of its discussions in public meetings. A major effort was made to communicate with organizations, individuals, and the media.

The present Commission conducted discussions largely in the public eye. Thus, the need for an extensive airing of the Commission's report and the reasons for reform is not nearly as great. Those with a direct interest in bankruptcy laws have been heard from.

What are the reasons for reform? While premised on the Bankruptcy Act of 1898, the Bankruptcy Code contained many new and untested ideas, an expansion of Chapter 13, greater protection for the debtors under 362, the promulgation of the Rules for Business Reorganizations, for instance. We have now had 20 years to learn the new concepts and procedure and how the courts interpret it and apply the Code.

The Code has been tested, and while adjusted periodically, has found to be lacking. In addition, the world is a much different place than it was 20 years ago. Bankruptcy cases and filings have grown exponentially. Without question, credit and lending policies have changed. More people have access to credit now than was seriously considered 20 years ago.

One of the factors contributing to our robust economy is consumer spending, financed, to a large degree, with the consumer debt. If credit is curtailed to protect against excessive losses, many of those who borrow and spend wisely, but do not have sufficient assets to collateralize a loan, will be unable to obtain credit, and the economy will shrink.

The Commission, as you know by now, was greatly politicized and deeply polarized. There was no attempt to forge a compromise on some of the most important topics, such as the consumer recommendations and the general Chapter 11 issues. The Commission began, under the chairmanship of former Congressman Mike Synar of Oklahoma. His unfortunate and untimely death early in his work deprived the Commission of his ability to forge a consensus, an attribute for which he was well known.

Mr. GEKAS. Will the gentleman draw his conclusions as best he can now?

Mr. SHEPARD. I will. Clearly, bankruptcy reform is necessary. We have had 20 years of experience with the Code, and we have now found it to be shortcoming.

Lastly, I would hope that Congress, when addressing these needs, keeps in mind that satisfying the needs and demands of the debtors, creditors, lawyers and judges will make them happy, but will it be in the best interests of the public, the 260 million people who did not file bankruptcy in 1998 and yet are required the bear the burden of the system.

Thank you.

[The prepared statement of Mr. Shepard follows:]

PREPARED STATEMENT OF JAMES I. SHEPARD, ESQUIRE, BANKRUPTCY TAX CONSULTANT, FORMER MEMBER OF THE NATIONAL BANKRUPTCY REVIEW COMMISSION, FRESNO, CA

I. INTRODUCTION.

Thank you for inviting me to speak today. It was an honor to be appointed to serve on the National Bankruptcy Review Commission and to have the opportunity to seek improvements in the bankruptcy laws of this country. Today, I will comment upon some of my observations regarding the Commission's work, its process, and the need for bankruptcy reform The two years of serving on the Commission, where hearings were held nation wide and presentations made by debtors' lawyers, creditors' lawyers, bankruptcy judges, and their organizations and representatives of numerous interested groups, easily leads one to the conclusion that bankruptcy has grown too important to entrust to those who work within the bankruptcy industry, those who profit from the bankruptcy system—the drafting of bankruptcy laws should not be left to those who have a vested interest in the implementation of those laws, either creditors or debtors.

A. Bankruptcy is a Big Business.

In studying the need for bankruptcy reform legislation, I would hope that the members of Congress keep in mind that there are only two things in bankruptcy for the players in the system, the lawyers and other professionals, money and power—the Bankruptcy Code and courts provide the power and the system provides the money. The recently released statistics on case filings in 1998 has produced some interesting inferences. If the debtors' lawyers who filed the 44,367 business cases in 1998 received (or will receive) an average of $30,000 in fees, a conservative estimate according to most bankruptcy judges, that group received (or will receive) a total of over $1.3 billion dollars. If the consumer debtors' lawyers received an average of $1,000 for each of their 1,398,182 cases, a reasonable estimate, that group received nearly $1.4 billion dollars, for a total of approximately $2.7 billion dollars paid to the debtors' lawyers. Assuming that the creditors' lawyers were paid just half of that amount and adding in the accountants, turn-around specialists and other hangers-on, bankruptcy is easily a $5 billion dollar-a-year industry, at the expense of the American public; and these figures don't include any of the costs of the judicial system, the costs of administering the cases, or the debt that was discharged. The numbers point to a conclusion which is entirely inescapable, bankruptcy is a big business for lawyers and other professionals.

B. The Proper Role of the Bankruptcy Courts and Bankruptcy Law.

Further, it must be recognized that bankruptcy courts cannot function as a "court of all social ills," real or perceived. Section 105(a) of the Bankruptcy Code—which, in the words of Judge Robert Ginsberg, who also served on the Bankruptcy Review Commission, is the "last bastion of a desperate lawyer"—is not the authority for a court to rewrite nonbankruptcy law according to the result it seeks. Bankruptcy judges must be discouraged from rendering result oriented decisions, those where the Bankruptcy Code is read in a manner never contemplated by Congress; such judicial legislation creates law that was not intended and invades the province of Congress. The Bankruptcy Code cannot be the source of omnipotent power, staving off the demands of creditors and rewriting law to suit the needs of every individual debtor. Nor can every small business with overwhelming financial problems be allowed to remain sheltered in that hospice of dying businesses, chapter 11, until all assets are wasted and the list of creditors is longer than before. Where the courts have strayed from Congressional intent Congress must establish clear limitations and definitions to redirect not only the "rogue" judges but the majority of our judges who are intelligent and well meaning, but often are lacking adequate guidance because the Code is vague.

The Constitution states that Congress shall "establish uniform laws on the subject of bankruptcies throughout the United States"—that bankruptcy law will be federal law to achieve uniformity as a part of the regulation of commerce—and to prevent fraud where debtors may have relocated property in other states.[1] Public respect for the law is an attribute that must be fostered and protected. Where bankruptcy law, or any law, strays far beyond the founders' intent and creates special rights for a few, whether motivated by a true sense of altruism or a desire to fulfill the vision of a few, this respect is lost and we all suffer. Thus, where bankruptcy becomes too appealing or grants relief to those who are undeserving, those who simply don't want to pay their debts but have the ability to do so, the law must be changed.

Where taxpayers have cheated on their returns, for instance, but are relieved of the obligation to pay, when they are otherwise not entitled to relief, the law must be changed. Where bankruptcy becomes the highly profitable playground of a few who are able to manipulate the law and the system to obtain unintended benefits, the use of "stealth provisions,"for instance, designed to obtain relief for nondebtors not otherwise permitted under law by obfuscating the language in Chapter 11 plans, the law must be changed. Where the law and the rules are overly complex or vague and inconsistently applied and the costs of participation in the process become prohibitive it must be changed. And where the costs of bankruptcy to the public, whether in increased interest rates, increased restrictions on credit, increased costs of goods, or increased costs of government, whether because of loss of revenue or the expenses of protecting the public interests, become excessive, the law must be changed. One county property tax assessor said, "Just tell me how much and we can adjust the rates to make up the difference." The loopholes and "gotcha" provisions which prevent parties from protecting their legitimate interests must be eliminated.

C. How We Got Here.

During the two plus years of its existence, the prior Commission, the Commission on the Bankruptcy Laws of the United States, conducted four public hearings over only eight days and 21 executive sessions over 44 days and filed its report with the President, the Chief Justice and the Congress on July 30, 1973. By remarkable coincidence, due to the preoccupation of Congress with the hearings regarding the possible impeachment of President Richard Nixon the law which became the Bankruptcy Code was not introduced until January 4, 1977. The Bankruptcy Code became law as title 11, United States Code, on the enactment of the Bankruptcy Reform Act of 1978; the much amended Bankruptcy Act of 1898 was our bankruptcy law until the Bankruptcy Code became law in 1979.

The prior Commission was faced with the daunting task of evaluating and revising a law which had served the country for 90 years without a major change since the promulgation of consumer bankruptcy laws in the Chandler Act of 1938, during the depression. That Commission had to determine whether to discard the Act of 1898 entirely and start all over or to pick and chose which parts of the existing bankruptcy law should be saved, which should be revised and which should be discarded. The charge to the prior Commission was to "study, analyze, evaluate, and recommend changes" in the Bankruptcy Act of 1898. The prior Commission conducted it's business in a collegial fashion, for the most part out of the public view, and was given the freedom to examine bankruptcy law in a more global fashion. The prior Commission devoted over a quarter of the $705,500 dollars it spent on seven commissioned studies, including a study by the Rand Corporation at a cost of $150,000.

In comparison, the National Bankruptcy Review Commission, established under the Bankruptcy Reform Act of 1994, was given a more limited charge, it was told that Congress was "generally satisfied with the basic framework established in the current Bankruptcy Code." The Review Commission began its work when it first met in October of 1995 and held virtually no executive sessions. It held, instead, 21 national and regional public hearings over 35 days, attended by more than 2,600 people, devoting almost half of its entire budget to public meetings, communication and outreach. The Review Commission conducted its business largely in the public eye. Thus the need for an extensive airing of the Commission's report and the reasons for reform is not nearly as great; those with a direct interest in bankruptcy laws have been heard from.

[1] THE FEDERALIST NO. 42, at 217 (James Madison) (Garry Wills ed., 1982).

D. The Reasons for Reform.

The Bankruptcy Code, while attempting to adhere to prior law, in large part, made sweeping, untested changes in many areas. The expansion of chapter 13 for consumer bankruptcies, greater protection under the section 362 stay of proceedings for debtors in general, the promulgation of the rules for business reorganizations, and the greater restriction on the ability of government to function, for instance, were new to the Code. We have now had twenty years to learn how the new concepts and procedures work and how the courts interpret and apply the new Code; twenty years to experiment with various attempts to "tweak" the Code to try to alleviate some of its shortcomings. The Code has been tested and, while adjusted periodically, has been found to be lacking. The public and many individuals have been adversely affected in many ways.

Perhaps of greater importance, the world is a much different place than it was twenty years ago. At the time of the enactment of the Code, there were a little more than 182,000 consumer bankruptcy filings, both straight liquidations and repayment plans. In 1998 there were just short of 1.4 million personal bankruptcy filings, an increase of more than 750 %. In the same time, the population has grown only a little more than 21 %. Twenty years ago there were some 32,000 business filings. In 1998, although business filings have been on a decline, thanks to the healthy economy, there were still more than 44,000 business filings.

We are celebrating a robust economy which has continued to expand longer than thought possible. When considering bankruptcy reform the affect of an overly generous bankruptcy system must be kept in mind. Without question, credit and lending policies have changed and more people have access to credit than was seriously considered twenty years ago. One of the factors contributing to the robust economy is consumer spending, financed to a large degree with consumer debt. There are those that attribute the record breaking number of consumer filings to what they perceive as "irresponsible lending." But the current methods of extending credit to the borrowers who were not considered credit worthy twenty years ago are not susceptible to the "fixes" suggested by the debtors' advocates. If the availability of credit were curtailed, to eliminate the abuses of the irresponsible borrowers, those borrowers who are responsible and pay their debts, but do not have sufficient assets to collateralize a loan, as was required twenty years ago, would be denied access to credit—it was difficult to obtain credit without having credit.

The law should not make it too easy to file bankruptcy but should demand personal responsibility of those that file. The law cannot allow any of the parties to ignore the rules and abuse the system. Where consumers are able to incur debt and spend irresponsibly and then be relieved of the obligation to repay, the public attitude towards the virtue of paying one's debts is lost, to the ultimate damage to our economy. A column recently appearing in the San Francisco Examiner,"[2] first noted the interrelationship between consumer consumption, consumer marketing, excessive consumer debt, particularly due to irresponsible spending, and the soaring rate of consumer bankruptcies, then asked, "When debt is checked, through either tighter credit or the wake-up call many consumers will have, will our economic expansion slow?" Bankruptcy reform will encourage responsible use of credit.

In the case of business bankruptcies, the vision guiding promulgation of the rules for chapter 11 reorganizations has not been fulfilled. In the majority of chapter 11 cases, generally all but the largest cases, the present rules have been found woefully inadequate in keeping cases moving towards successful reorganization. In spite of the favorable business economy fewer than one in four debtors confirm a plan and an even smaller number successfully complete a plan. Quoting from a respected bankruptcy treatise[3] the Bankruptcy Review Commission's report states:

> Far too [frequently], counsel file a Chapter 11 petition for a debtor, the business of which is in such straits and so incapable of recovery that the Chapter 11 case is nothing more than a holding pattern before an inevitable conversion to Chapter 7 or dismissal. Such a case serves no useful purpose and instead merely prolongs a painful process. Clients would be far better served if counsel examined the economic potential of the business before filing a petition to "rehabilitate" a moribund debtor.[4]

The principal weaknesses in the chapter 11 provisions of the Code are a lack of supervision of the debtor, particularly in the vast majority of cases where there is no active creditors' committee, the lack of clear deadlines for filing and confirming a

[2] Julianne Malveaux, *On the Economy*, S. F. Examiner, March 7, 1999 at B–2.

[3] ASA S. HERZOG & LAWTENCE P. KING, COLLIER BANKRUPTCY PRACTICE GUIDE ¶ 84.02[1][D] (1992).

[4] REP. OF THE NAT'L BANKR. REVIEW COMM'N 612 (1997).

plan of reorganization, cumbersome requirements for disclosure statements, the lack of significant reporting requirements, and inadequate control of serial filers. All of these problems are addressed in H.R. 833, the Bankruptcy Reform Act of 1999.

Similar weaknesses in other areas of the Code have developed over the past twenty years, many of which are addressed in H.R. 833.

E. The Commission's Process.

When the Bankruptcy Review Commission was first formed it was thought that it would be an opportunity for a collegial, objective study of the Code and its problems. Unfortunately, events proved that such would not be the case. The Commission quickly became politicized and, thus, very polarized; in some cases the personal agenda of a few individuals, rather than objective, scholarly study by the group, was the driving force in promulgating the Commission's recommendations. There was no effort to forge a compromise where the members were deeply split on important topics, such as the consumer recommendations and the General Chapter 11 Issues.

The depth of the chasm in the Commissioners' views and the disagreeable manner in which the report was written are reflected in the Commissioners' dissents to the report, particularly the Dissent From the Process of Writing the Commission's Report.[5] The dissent of Commissioners John A. Gose and Jeffrey H. Hartley, concurring with the Recommendations for Consumer Bankruptcy Law submitted by the Honorable Edith H. Jones, observed that the report's consumer "Framework" was unacceptable , that it was presented on a "take ir or leave it" basis. The discrete problems and complaints about consumer bankruptcy law were not presented in a manner which permitted their separate consideration.

The Commission began under the chairmanship of former Congressman Mike Synar of Oklahoma. His unfortunate and untimely death early in its work deprived the Commission of his ability to forge a consensus, an attribute for which he was well known. Not all of the Commission's recommendations suffer from the lack of compromise. Remarkable exceptions are the Small Business Proposals, which are the product of much objective study and compromise and the very capable guidance of Stephen Case, Senior Advisor to the Small Business Committee, and the tax proposals, which were guided by Professor Jack Williams.

F. Conclusion.

Bankruptcy reform is clearly necessary. Twenty years of experience with the Code has revealed significant shortcomings, many of which are addressed in H.R. 833, the Bankruptcy Reform Act of 1999. There are those who argue that the reform process is moving too fast, those that advocate maintaining the status quo. Many of those who work within the bankruptcy industry and who have profited by the system argue against change, whether because of genuine belief that current law is best, because of the inconvenience in being required to learn new rules and procedures, or because of a potential loss of revenue. Those who have the advantage created by loopholes and shortcoming in the Code do not want the system changed. During the Commission's hearings, the debtors' lawyers quickly came to sound like a "broken record," time and again repeating the overused saw, "if it ain't broke don't fix it." But principally those who argue that further delay is required simply do not like the bill; it does not meet their personal vision of what bankruptcy should be and they hope that additional time will give them the opportunity to derail reform.

In my testimony at an earlier Congressional hearing, I observed that one of the Commission's greatest failures was in "studying the fish from inside the fish bowl when it should have been looking at the broader perspective from outside the tank." Solely relying on the statements, testimony and submissions of those who work within the bankruptcy industry, those who presented their views which are reflected in the Commission's report, presents the views of those with a vested interest in the bankruptcy process. The opinions of those within the bankruptcy industry do not always represent the best interests of the public.

Thus, it becomes the duty of Congress to consider the rights and interests of the public, not just the players in the system. Bankruptcy law must be kept in its proper perspective. Congress and the United States Government must serve all the citizens of this country, not just the debtors and creditors, but, more importantly, the 260 million people who did not file bankruptcy in 1998 and yet are required to bear the burden of the system. It must be remembered that the Bankruptcy process is but one function of government, a substructure within the panoply of governments, state, federal and local; which must provide for all citizens.

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[5] In what appears to be an intentional attempt to blunt the impact of the fourteen dissents, they are not separately paginated, making it difficult, if not impossible, to cite, but are simply collected at the back of the report.

Mr. GEKAS. We thank the gentleman.

We turn to Professor Posner for the allotted 5 minutes.

STATEMENT OF ERIC A. POSNER, PROFESSOR, UNIVERSITY OF CHICAGO LAW SCHOOL, CHICAGO, IL

Mr. POSNER. Thank you, Mr. Chairman.

The current Bankruptcy Code was motivated, in part, by a report issued in 1973 by a Commission that had been created by Congress to evaluate American bankruptcy law.

Of the reasons for bankruptcy reform listed in the report two stand out to modern eyes.

The first reason for reform was the rapid increase in the number of bankruptcies, which had gone from about 10,000 in 1946 to about 200,000 in 1967. The second reason was that the fresh start was "insufficiently generous." You get no sense from the report that there is any contradiction in saying that both the rapid increase in bankruptcies and the insufficient generosity of the fresh start are problems.

The Commission's main recommendation with respect to consumer bankruptcy was to create a uniform system of Federal exemptions to replace the bankruptcy law's incorporation of State exemptions. The final law, as you know, created Federal exemptions that served as a de facto floor in those States that did not subsequently exercise their right to opt out of the Federal exemption system.

After the Bankruptcy Code was enacted in 1978, the number of bankruptcy filings shot up and is now about 1.4 million in 1998. Almost all of the growth has been driven by the increase in consumer bankruptcy filings, and because of this, some people have naturally assumed that the exemption rules and other consumer bankruptcy provisions of the 1978 Code are responsible for the increased filing rate.

However, the effect of the enactment of the Bankruptcy Code on consumer bankruptcy filings is hard to gauge. There are some reasons for believing that the Code is the culprit. It is true that the Federal exemptions created in 1978 were more generous than the exemptions in most States at that time and so people in the less generous States could now do better by filing for bankruptcy. However, empirical studies have come to conflicting results, and analysis has been confounded by the occurrence of other events that probably had an influence on bankruptcy filings. Perhaps the most important, in my view, was the de facto deregulation of State interest rate ceilings in 1978.

Since 1978, Congress's attempts at bankruptcy reform have been motivated, in part, by concern about the rapid increase in bankruptcy filings. In 1984, it introduced the substantial abuse test in Section 707(b), which attempted to force high-income debtors into Chapter 13, although it is not clear how much effect this law has had. Yet in 1994, Congress increased the generosity of exemptions. It increased the homestead exemption, for example, from $7,500 to $15,000. A married couple could exempt $30,000 of home equity. Taken together, it seems that the net result of post-1978 bankruptcy reform was an increase in the generosity of the bankruptcy system.

So we have a strange repetition of history. The Bankruptcy Code was motivated, in part, by concern about the number of bankruptcy filings, yet resulted in a more generous bankruptcy system. Bankruptcy reform has been motivated by concern about the number of bankruptcy filings and yet has also resulted in a more generous bankruptcy system.

Why has this occurred? Well, it is hard to say, but it seems that the answer lies, in part, in the influence of interest groups. As I have argued recently, the people with the most at stake and with the most influence on bankruptcy reform in 1978 were bankruptcy lawyers, bankruptcy judges, consumer groups of various sorts and creditors. Lawyers, judges and consumer groups lobbied hard for a more generous bankruptcy system, and it appears they got one. The creditors did not have as much influence as one might expect, perhaps because their interests conflicted. Bankers seem to care most about the treatment of mortgages, for example, not about exemptions, while other commercial lenders cared about a variety of issues, like reaffirmation agreements, the right to redemption, as well as exemptions.

The people least-well represented in the hearings leading up to the 1978 Code were the ordinary members of the public, the people who borrow money routinely. Although lawyers and consumer groups claimed to represent the public, it is more plausible that they were interested in helping people who have already incurred a great deal of debt and so might need the services of a bankruptcy lawyer. In addition, the legislative process lasted over a decade and received little attention from the media. Bankruptcy law was then a backwater; no one predicted that bankruptcy reform would change this, so no one alerted the public to what was happening.

These considerations suggest that we should not be complacent about the status quo. The status quo bankruptcy system probably reflects the interests of lawyers and maybe certain kinds of creditors as well. We should be cautious about assuming that the current generosity of the bankruptcy system reflects the public's interest and that the public would be opposed to reform.

Does the public have an interest in means testing? It is hard to see why it wouldn't. The public has always objected to welfare benefits, for example, going to the undeserving poor, and it would seem that for similar reasons the public would object to bankruptcy protection going to higher income individuals.

The people who would be most harmed by means testing would not be the public in general; they would be the bankruptcy lawyers. Bankruptcy lawyers would most likely see a decline in business from those people who, I assume, are their most lucrative clients; namely, the higher income people seeking to escape their debts.

[The prepared statement of Mr. Posner follows:]

PREPARED STATEMENT OF ERIC A. POSNER, PROFESSOR, UNIVERSITY OF CHICAGO LAW SCHOOL, CHICAGO, IL

The current Bankruptcy Code was motivated in part by a report issued in 1973 by a Commission that had been created by Congress to evaluate American bankruptcy law. Of the reasons for bankruptcy reform listed in the report, two stand out to modern eyes. The first reason for reform was the rapid increase in the number of bankruptcies, which had gone from 10,196 in 1946, to 208,329 in 1967.[1] The second reason was that the fresh start was "insufficiently generous." You get no sense from the report that there is any contradiction in saying that both the rapid increase in bankruptcies and the insufficient generosity of the fresh start are problems. But it seems clear that if the fresh start is made more generous, more people will file for bankruptcy; and if you want fewer people to file for bankruptcy, then you have to make the fresh start less generous.

The Commission's main recommendation with respect to consumer bankruptcy was to create a uniform system of federal exemptions, to replace the bankruptcy law's incorporation of state exemptions. It did not explain this recommendation in any detail, but it may have believed that incorporation of state exemptions was unfair to people who lived in states with miserly exemptions. (State exemptions, then as now, ranged from the extremely miserly to the extremely generous.) The amounts chosen—for example, $5000 homestead—were also not explained. Subsequently, the House sought a more generous federal floor (for example, $10,000 homestead), while the Senate sought to retain incorporation of state exemptions. The final law contained an odd compromise—intermediate exemptions (for example, $7500 homestead) as a de facto floor in those states that did not opt out of the federal exemptions.

After the Bankruptcy Code was enacted in 1978, the number of bankruptcy filings shot up, and has risen almost every year. In 1998, there was a new record: about 1.4 million. Almost all of the growth has been driven by the increase in consumer bankruptcy filings. Because of this, people have naturally assumed that the exemption rules and other consumer bankruptcy provisions of the Code are responsible for the increased filing rate.

However, the effect of the enactment of the Bankruptcy Code on consumer bankruptcy filings is hard to gauge. There are some reasons for believing that the Code is the culprit. The federal exemptions created in 1978 were more generous than the exemptions in most states at that time, and so people in the less generous states could now do better by filing for bankruptcy. And although most states opted out of the federal system, many states increased the generosity of their own exemptions quite substantially over the 1980s and 1990s. As a result, some academics believe that the Bankruptcy Code caused the increase in consumer bankruptcies. However, empirical studies have come to conflicting results, and analysis has been confounded by the occurrence of other events that probably had an influence on bankruptcy filings. Perhaps the most important was the de facto deregulation of state interest rate ceilings in 1978.[2] This, and related factors, enabled creditors to issue credit to higher-risk debtors than they had in the past, and these are the very debtors who are most likely to be unable to repay their debts.

Since 1978, Congress' attempts at bankruptcy reform have been motivated in part by concern about the rapid increase in bankruptcy filings. In 1984, it introduced section 707(b)'s substantial abuse test, which attempted to force high-income debtors into Chapter 13, although it is not clear how much effect this law has had. Yet in 1994, Congress increased the generosity of exemptions. It increased the homestead exemption, for example, from $7500 to $15,000. A married couple can exempt $30,000 of home equity. Taken together, it seems that the net result of post-1978 bankruptcy reform was an increase in the generosity of the bankruptcy system.

So we have a strange repetition of history. The Bankruptcy Code was motivated in part by concern about the number of bankruptcy filings, yet resulted in a more generous bankruptcy system. Bankruptcy reform has been motivated by concern about the number of bankruptcy filings, and yet has also resulted in a more generous bankruptcy system. Why has this occurred?

The legislative history of the Bankruptcy Code illustrates the widely held view that legislation will reflect the interests with the most at stake, and not necessarily the interests of the diffuse and unorganized public. As I argued in a recent article, the people with the most at stake, and with the most influence on bankruptcy reform in 1978, consisted of bankruptcy lawyers, bankruptcy judges, consumer groups, and creditors. Lawyers, judges, and consumer groups lobbied hard for a more generous bankruptcy system, and they got one. The creditors did not have as much influence as one might expect, perhaps because their interests conflicted. Bankers seemed to care most about the treatment of mortgages, while unsecured lenders cared more about reaffirmation agreements, the right to redemption, and exemp-

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[1] Sources for statistics and arguments can be found, except where otherwise indicated, in Eric A. Posner, The Political Economy of the Bankruptcy Reform Act of 1978, 96 Mich. L. Rev. 47 (1997), which is attached to this statement.

[2] See Diane Ellis, The Effect of Consumer Interest Rate Deregulation on Credit Card Volumes, Charge-Offs, and the Personal Bankruptcy Rate, Bank Trends, No. 98–05 (1998).

tions. Complicating these matters was the question of whether exemptions should be controlled by the states or by Congress, a question that has so far been resolved in favor of the states.

The people least well represented in the hearings leading up to the 1978 Code were the ordinary members of the public who need to borrow money. Although lawyers and consumer groups claimed to represent debtors, it is more plausible that they were interested in helping people who have already incurred a great deal of debt, and so might need the services of a bankruptcy lawyer. In addition, the legislative process lasted over a decade and received little attention from the media. Bankruptcy law was a backwater; no one predicted that bankruptcy reform would change this, so no one alerted the public to what was happening.

These considerations suggest that we should not be complacent about the status quo. The status quo bankruptcy system probably reflects the interests of lawyers and certain kinds of creditors. We should be cautious about assuming that the current generosity of the bankruptcy system reflects the public's interest, and that the public would be opposed to reform. Does the public have an interest in means testing? It is hard to see why it would not. The public has always objected to welfare benefits going to the undeserving poor; it would seem that for similar reasons the public would object to bankruptcy protection going to higher-income individuals. The people who would be most harmed by means testing would not be the public in general; they probably would be bankruptcy lawyers. Bankruptcy lawyers would see a decline in business from those people who are likely to be their most lucrative clients—wealthy people seeking to escape their debts.

ARTICLE: THE POLITICAL ECONOMY OF THE BANKRUPTCY REFORM ACT OF 1978

ERIC A. POSNER*

96 Mich. L. Rev. 47

*Assistant Professor of Law, University of Pennsylvania. B.A. 1988, Yale; J.D. 1991, Harvard.—Ed. Thanks to Barry Adler, Jack Ayer, Douglas Baird, Lucian Bebchuk, Frank Easterbrook, Bob Feidler, Rich Hynes, Ed Kitch, Ken Klee, Kevin Kordana, Richard Levin, Harvey Miller, Randy Picker, Ed Rock, David Skeel, Stephen Williams, and participants at a talk at the University of Virginia Law School and at a conference sponsored by the Institute for Law and Economics, University of Pennsylvania. Special thanks to Alan Schwartz and Ron Trost, who prepared formal comments for the talk at Penn, and to Andrew Gallo, for valuable research assistance.

INTRODUCTION

Why do we have a bankruptcy law? The conventional story is that bankruptcy law reflects two requirements of a modern commercial economy: a method for the orderly payment of debts owed to multiple creditors and a means to ensure that individual debtors retain sufficient assets and rights to maintain a dignified or at least nonpenurious existence. No doubt this story contains elements of the truth, but it also has many limitations. The story does not explain many significant attributes of the Bankruptcy Code, including the administrative structure it establishes, its reliance on a mixture of federal- and state-determined rights, and its balancing of interests between creditors and debtors.

When commentators try to explain these aspects of the Bankruptcy Code, they generally describe them as the result of conflicts between debtor interests, on the one hand, and creditor interests, on the other. The outcome is explained as just a compromise reflecting the relative political power of each group. On reflection, however, this explanation is not satisfactory. It does not take account of the following factors: (1) different kinds of creditors have different, and often conflicting, interests; (2) other actors have a strong interest in the Bankruptcy Code, including lawyers, judges, agency officials, managers and shareholders of corporations, and politicians; and, perhaps most significantly, (3) *debtors*, considered as the class of people who are potential beneficiaries of bankruptcy law, do not compose an organized and politically influential group. A satisfactory explanation of the Bankruptcy Code must take into account the interests of all relevant parties and the extent of their political power.

An understanding of the political influences on the origin of the Bankruptcy Code is of considerable importance at the present time. In 1994 Congress created a National Bankruptcy Review Commission for the purpose of evaluating the bankruptcy system and proposing amendments.[1] The Commission has held hearings, has voted on a variety of proposals, and is expected to issue a report in October, 1997.[2] One question that has not received much attention concerns the extent to which political realities constrain the Commission's behavior and the extent to which they will affect Congress's reception of its report. One way to approach this question is to look back at the political background of the Bankruptcy Reform Act of 1978, develop a political theory of its origin, and use this theory to shed light on the political determinants of the bankruptcy amendment process.

These are the goals of this article. In particular, this article analyzes the legislative history of the Bankruptcy Reform Act of 1978[3] and related materials, in the hope of describing the influence of interest groups on the final statute. It has, of course, long been assumed that certain narrow provisions of the 1978 Act reflect the influence of interest groups—for example, the section that gives special protection to security and lease interests in aircraft.[4] This article goes farther and argues that fundamental elements of the 1978 Act reflect political compromises among competing interest groups. In particular, I claim (1) that the allocation of powers to bankruptcy judges and trustees resulted from efforts by Congress to increase its patronage opportunities, (2) that the provisions on exemptions resulted from a conflict between federal and state officials over the power to make transfers to local interest groups, and (3) that the provisions on business reorganization resulted from efforts by managers' lawyers and large creditors to maximize their influence on the reorganization of distressed firms, at the expense of other interests, such as equity and small debt. I make similar claims about the provisions on reaffirmation, student loans, and the fraud exception to the right to discharge.

These conclusions grow from the application of ideas from public choice theory to the legislative history of the Bankruptcy Code. The use of this methodology represents a departure from most bankruptcy scholarship, which is normative, doctrinal, or empirical. This article, in contrast, analyzes the political determinants of bankruptcy law: its contribution is its description of the ways in which the political process resulted in a particular kind of bankruptcy system.[5]

Because of the length of the article, a brief overview will be helpful to the reader. The argument begins in Part I with a general discussion of the features that are generally believed to characterize a socially desirable bankruptcy law. This discussion provides a baseline for identifying distortions caused by the influence of interest groups. To clarify the nature of these political interests, Part II contains a stylized cast of characters, categorized into debtors, creditors, elected and unelected federal authorities, state authorities, and lawyers, and analyzes their interests in bankruptcy reform. After some methodological notes in Part III, Part IV describes the legal and political background of the Code. It describes the 1898 Act, as amended, that prevailed prior to the enactment of the Bankruptcy Reform Act in 1978; it discusses the sources of dissatisfaction with the 1898 Act; and it summarizes the legislative history of the 1978 Act.

Next come the arguments about the influence of interest groups on the final statute. Part V analyzes the administrative structure created by the 1978 Act. Part VI analyzes the exemption rules. Part VII analyzes the provisions relating to corporate reorganization. Part VIII analyzes three less significant issues that nonetheless generated a great deal of controversy: the dischargeability of educational loans, the re-

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[1] *See* Bankruptcy Reform Act of 1994, Pub. L. No. 103–394, 603, 108 Stat. 4106, 4147 (codified at 11 U.S.C. cmt. preceding 101 (1994)).

[2] *See* National Bankruptcy Reform Commn., *NBRC Fact Sheet* (last modified Aug. 12, 1997) <http://www.nbrc.gov/facts.html>.

[3] Pub. L. No. 95–598, 92 Stat. 2549 (codified as amended at 11 U.S.C. (1994), in scattered sections of 28 U.S.C. (1994), and in scattered sections of other titles of U.S.C. (1994)). The law had no official title and has been called the Bankruptcy Act, the Bankruptcy Reform Act, and the Bankruptcy Code; however, for precision, I use the last term to refer to the bankruptcy law as it currently exists—that is, as amended since the 1978 Act.

[4] See 11 U.S.C. 1110 (1994).

[5] Such a project is long overdue for so significant a piece of legislation as the Bankruptcy Code. Theoretically informed analyses of legislative history or the law are common for other areas of the law. *See, e.g.*, Mark Barenberg, *The Political Economy of the Wagner Act: Power, Symbol, and Workplace Cooperation*, 106 HARV. L. REV. 1379 (1993) (labor law); Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10 (1991) (laws governing corporate finance); Roberta Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111 (1987) (state takeover statutes); Alan Schwartz & Robert E. Scott, *The Political Economy of Private Legislatures*, 143 U. PA. L. REV. 595 (1995) (private legislatures). The only sustained analysis of bankruptcy law from this perspective focuses on post-1978 law. *See* Susan Block-Lieb, Congress's Temptation to Defect: A Political and Economic Theory of Legislative Resolutions of Financial Common Pool Problems (1997) (unpublished manuscript, on file with the author).

affirmation of debts, and the fraud exception to discharge. The conclusion, Part IX, draws out the implications of the arguments for bankruptcy reform and discusses some of the proposals currently before the National Bankruptcy Review Commission.

I. NORMATIVE THEORIES OF BANKRUPTCY LAW

In public choice studies it is standard to describe the optimal version of the law in question and use interest group theory to explain the observed deviations. This approach raises difficulties because the optimal version of a particular law may be controversial. Bankruptcy law is no exception. Nevertheless, a few comments on the academic debate concerning optimal bankruptcy law may provide a useful, if rough, baseline for the political analysis.

A. Procedures for the Satisfaction of Multiple Claims

The optimal bankruptcy law solves a collective action problem that arises when a debtor defaults on loans from several creditors. Default frequently occurs when a debtor borrows from multiple creditors and has too few assets to pay back all of them. In the absence of a bankruptcy system, the creditors would have an incentive to race to the courthouse and obtain a judgment before the other creditors realized that the debtor is insolvent. The reason is that under state law the first creditor to obtain a judgment against a debtor has a better chance to seize the debtor's assets than later creditors do. The race to the courthouse creates several costs, including the cost of monitoring the debtor closely in order to be the first to detect an impending default and the loss of the going-concern or relationship-specific value of assets that occurs when solvent debtors with temporary cash-flow problems are driven into insolvency because creditors prefer seizing assets immediately to maximizing the value of all the debtor's assets. Bankruptcy law reduces these costs by providing for an orderly collection procedure, including (1) an automatic stay that prevents creditors from pressing a claim unless it would be destroyed by the delay, and (2) a distribution system that for the most part respects prebankruptcy entitlements.[6]

In theory, the collective action problem could be mitigated through bargaining. Ex ante, creditors can protect themselves with security interests, debt covenants, and other contractual provisions; in the absence of the Bankruptcy Code's restrictions on waivers they could contractually provide for a post-insolvency division of assets.[7] Because the rules designed to ensure an orderly collection procedure also affect such bargaining, and the influence of rules on bargaining can be analyzed only with great difficulty, the optimal design of the collection procedure in bankruptcy remains poorly understood.

B. Discharge

The bankruptcy policy of discharge for consumer debtors does not have as clear an explanation. The puzzle is that debtors, like creditors, want to minimize the cost of credit. The right to discharge, however, increases the cost of credit, because it prevents creditors from collecting some of their debts, and they must pass on their costs to debtors in the form of higher interest rates. Although debtors who face unanticipated costs ex post should be delighted with the chance of discharging their debts, the policy injures the interests of debtors as a class. Another way of putting this is that people who already have a lot of debt may support discharge; but the vast majority of people, who, whether or not they already have debt, expect to continue taking on debt into the future, should object to the (nonwaivable) right to discharge.[8]

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[6] For discussions of these familiar points, see Douglas G. Baird, *A World Without Bankruptcy*, LAW & CONTEMP. PROBS., Spring 1987, at 173; Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857 (1982).

[7] *See generally* Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311 (1993); Lucian Arye Bebchuk, *A New Approach to Corporate Reorganization*, 101 HARV. L. REV. 775 (1988); Randal C. Picker, *Voluntary Petitions and the Creditors' Bargain*, 61 U. CIN. L. REV. 519 (1992); Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEXAS L. REV. 51 (1992); Alan Schwartz, *Contracting About Bankruptcy*, 13 J.L. ECON. & ORG. 127 (1997); Alan Schwartz, *Bankruptcy Workouts and Debt Contracts*, 36 J.L. & ECON. 595 (1993); *see also* Barry E. Adler, *A Theory of Corporate Insolvency*, 72 N.Y.U. L. REV. 343 (1997) (arguing that investors might prefer ex ante routine liquidation of financially distressed firms).

[8] *See* Ronald A. Dye, *An Economic Analysis of Bankruptcy Statutes*, 24 ECON. INQUIRY 417 (1986).

There are two possible solutions to this puzzle.[9] The first assumes that most people see poverty as an evil and are willing to pay, through taxes, to see it reduced. The nonwaivable right to discharge supplements the welfare system in two useful ways. First, it discourages debtors from contracting out of the welfare system by using as collateral assets that are necessary to minimal well-being. Welfare laws prohibit the use of welfare payments as collateral; discharge law (along with exemption law) renders valueless "necessary" assets, however defined, and future income as collateral by barring creditors from collecting from them. Second, the right to discharge discourages high-risk behavior that would otherwise be an unavoidable side effect of welfare. Because the welfare system protects people from some of the downside risk of investments, it encourages people to take on too much risk. The right to discharge, however, forces creditors to raise interest rates, discouraging some debtors from engaging in risky investments whose cost is externalized on the taxpayer.

On another view, discharge is justified because debtors frequently take on more debt than they really want to. They do so because they are misinformed about the law or about their future resources, or because cognitive error prevents them from recognizing the risks that accompany debt. There may be elements of truth in this argument, but no one has shown that these problems are pervasive enough to justify a departure from the norm of freedom of contract, and no one has shown that the nonwaivable right to discharge—rather than waiting periods, mandatory disclosure statements, and similar laws—is the most appropriate response to them.

These arguments raise the issue of the optimal level of government for determining the value and kind of property that should be shielded from creditors by exemption laws. Most welfare law is determined by the states, rather than by the federal government, and one justification is that states have more information about local attitudes toward risk and poverty and a stronger incentive to respect them. This justification suggests that exemption law should be left in the hands of the states. A criticism of local control of welfare, however, is that states externalize the costs of poverty on other states.[10] This criticism suggests that local control of exemption law may also have social costs because of spillovers.[11] But the direction of the spillover is unclear. On the one hand, it is well known that some states, especially Texas in the nineteenth century, have chosen generous exemptions laws for the purpose of encouraging immigration. Competition for immigrants could lead to suboptimally generous exemption laws. On the other hand, it is also possible that states would choose suboptimally stingy exemption laws in order to drive impoverished debtors to other states. We will return to these issues in Part VI.

C. Reorganization

The purpose of reorganization is to preserve the going concern value of firms. A firm that enters bankruptcy and emerges intact but with a new capital structure may satisfy creditors' claims more effectively than a firm that is liquidated. There is controversy, however, over how reorganization should proceed. One question is whether the managers of the debtor should retain control over the debtor, on the theory that they alone possess the necessary expertise, or whether an independent trustee should control the firm during reorganization, on the theory that the managers have perverse incentives. Related questions include how much power different kinds of creditors should have over the plan, the court's role in approving the plan, and the protections given the creditors who vote against a plan.[12]

A more complex issue is whether reorganization law should be concerned solely with maximizing the ex ante value of firms or should serve more general social functions, such as minimizing the dislocation that employees would experience if a firm were liquidated, or spreading risk among various kinds of equity and debt inves-

[9] Both are discussed in THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 225–79 (1986) (discussing discharge and fresh-start policies); the first is discussed in Eric A. Posner, *Contract Law in the Welfare State: A Defense of the Unconscionability Doctrine, Usury Laws, and Related Limitations on the Freedom to Contract*, 24 J. LEGAL STUD. 283, 307–08 (1995).

[10] For a discussion of these issues, see F.H. Buckley & Margaret F. Brinig, Welfare Magnets: The Race for the Top (June 28, 1996) (unpublished manuscript, on file with author).

[11] *Cf.* Michael H. Schill, *Uniformity or Diversity: Residential Real Estate Finance Law in the 1990s and the Implications of Changing Financial Markets*, 64 S. CAL. L. REV. 1261, 1262, 1288–1304 (1991) (discussing real estate exemptions and related laws).

[12] *See, e.g.*, Bebchuk, *supra* note 7; Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganizations*, 83 COLUM. L. REV. 527 (1983). Some commentators argue that bankrupt firms should be auctioned off. *See, e.g.*, Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127 (1986).

tors.[13] Either view is theoretically possible, but the first view is more plausible. One problem with the second view is that no one has presented evidence showing that fewer jobs are lost when a firm reorganizes than when a firm is liquidated. In fact, reorganizations often involve the firing of employees, and liquidations often involve the selling off of entire components of a business without resulting in a substantial loss of employment. In addition, one must take account of the decline in the demand for labor outside the firm that results from keeping alive an inefficient firm. Another problem with the second view is that no one has provided a rigorous explanation of how reorganization mitigates dislocation. Such an explanation would show, among other things, that unemployment insurance, job-training programs, and other elements of the welfare system would fail to soften the transition more effectively than reorganization law does.

D. Administration

A final issue concerns the administration of the optimal bankruptcy law. Little can be said at a high level of generality about the optimal form of administration, but the important issues can be identified. These issues include: (a) the allocation of powers among the bankruptcy judge and the trustee; (b) the allocation of powers among bankruptcy judges and district judges; (c) appointment and tenure of bankruptcy judges, including the question of which level of government should have the appointment power (state or federal) and which branch of government (executive or judicial); and (d) similar questions with respect to the appointment and tenure of trustees.

II. CAST OF CHARACTERS

A. Debtors

The first category of players consists of debtors. Among consumer debtors it is useful to distinguish between "continuing debtors" and "overburdened debtors." Overburdened debtors are those debtors that gain more from the one-time transfer of wealth from creditors to debtors that occurs when discharge rules are made more generous than they lose from the higher interest rates that they will have to pay for loans in the future. Continuing debtors are those for whom this is not true. Overburdened debtors seek the expansion of their right to discharge; they also prefer a smooth administrative system if discharge is sufficiently generous. Continuing debtors presumably prefer the law of discharge and exemption that properly balances their desire for low interest rates and their desire for protection if they default on their loans, a balance that may (or may not) best be achieved through private contracting. Overburdened debtors may have a strong incentive to organize, particularly during economic downturns when their financial difficulties are most acute; continuing debtors have little incentive to organize.

It is also important to distinguish actual debtors, whether overburdened or continuing, from those who purport to represent them. The National Consumer Law Center, for example, claims to represent consumer debtors, but its members have distinct interests that conflict with the interests of debtors. For example, the members might prefer laws that generate business for themselves even though such laws might injure debtors in general and continuing debtors in particular.

In addition, the managers of corporate debtors have interests that conflict with the interests of the corporations or their shareholders. Managers have an interest in retaining control of the corporation even when new management would increase the value of the corporation.

Debtors as a class are not represented in the legislative history. Individual debtors—whether continuing or overburdened—do not give testimony. Corporate debtors are dumb and must speak through their putative representatives, the managers. Shareholders also do not make an appearance. The main debtor-related witnesses are lawyer groups, such as the National Consumer Law Center, and some individual lawyers who mainly represent debtors.

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[13] For discussions of these issues, see Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439 (1992); Douglas G. Baird & Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. CHI. L. REV. 739 (1988); Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 VA. L. REV. 155 (1989). *Compare* Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775 (1987) *with* Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815 (1987) (debating the basis of business bankruptcy policy).

B. Creditors

Although creditors as a group have many similar interests, they tend to specialize, and as a result creditors often came into conflict in the legislative history. Banks, represented by the American Bankers Association, issue mostly low-risk debt, both secured and unsecured. Credit unions, represented by the National Credit Union Association, issue low-risk debt that can be collected easily through payroll deductions. Finance companies, represented by the National Consumer Finance Association, issue high-risk debt, often secured by household goods and often collected through wage garnishment.[14] The National Association of Credit Management and the National Commercial Finance Conference represent a variety of businesses that extend credit to commercial debtors. Trade creditors are not represented, except in a diluted fashion by general institutions like the Commercial Law League. Involuntary or unsophisticated creditors, such as tort creditors and employees, are not directly represented, except that (some) union members are represented by (some) unions. Different creditors have different amounts of power at the state level and at the federal level.

Because creditors as a group have an interest in minimizing the cost of credit, they should support low exemptions, preserving prebankruptcy entitlements in bankruptcy, and efficient reorganization schemes.[15] But each kind of creditor has an interest in raising the costs of other creditors when doing so drives the customers of the latter into the arms of the former. For example, banks and other issuers of low-risk credit may favor exemptions for household goods in order to eliminate finance companies' means for ensuring repayment of their high-risk loans. Credit unions might prefer high priority for employees' wage claims against a bankrupt employer in order to reduce the chance that employees who lose wage claims will default on loans from credit unions. Another conflict arises because some creditors, such as banks, have many long-term loans in their portfolios, while other creditors, like finance companies, have many short-term loans in their portfolios. The first group would care more about the effect of bankruptcy reform on their existing assets than would the latter, which can more easily pass on additional costs to its customers.[16]

C. Elected Federal Officials

The most important elected federal officials in the legislative history were members of Congress (the various presidents do not appear to have taken much of an interest in bankruptcy policy). Members of Congress played two roles in the legislative history. First, they testified in favor of or against certain provisions, for example, the proposed nondischargeability of educational loans. Second, they voted. Members of Congress had an interest in using the opportunity of bankruptcy reform to effect self-serving structural changes in the government. As we shall see, they had an interest in creating new patronage positions and seizing the power to make patronage appointments from different levels of government (the states and localities) and from different branches of the federal government (the courts), and they had an interest in gaining control over areas of policy traditionally in the hands of the states, such as exemption policy. To be sure, the extent to which Congress could seize power from other elements of the government was limited by the independent political power of those elements. In addition, the goals of the House and the Senate did not always converge: the conventional wisdom is that the Senate is more sensitive to the interests of states with small, rural populations.

D. Unelected Federal Officials

Unelected federal officials included bankruptcy judges, federal judges, trustees, and agency officials. As we shall see, bankruptcy judges had a strong interest in elevating their status to something like that of the federal judges, and the federal judges had an equally strong interest in resisting this elevation lest it dilute their status. Existing trustees may have feared a weakening of their positions. A few federal agencies also had an interest in the legislation. The most important were the Securities & Exchange Commission, which under old law had an important role in

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[14] *See* Peter V. Letsou, *The Political Economy of Consumer Credit Regulation*, 44 EMORY L.J. 587, 631–36 (1995).

[15] One might argue that creditors should not care about proposed laws that would increase the cost of credit, because loans outstanding at the time of enactment are a small fraction of future loans, and creditors can pass on increased costs to future borrowers. But the lost business at the margin may be substantial, and the evidence indicates that the credit industry has found it worthwhile to try to influence legislation. *See* Vern Countryman, *Bankruptcy and the Individual Debtor—And a Modest Proposal to Return to the Seventeenth Century*, 32 CATH. U. L. REV. 809, 821–22 (1983); *infra* notes 189–90.

[16] Other important creditors include insurance companies and leasing organizations.

the reorganization of public corporations, and the Justice Department, which had a role in the nomination of judges.

E. Lawyers

Different kinds of lawyers had different attitudes toward bankruptcy reform. We distinguish among (a) lawyers who specialized in bankruptcy law and who were represented by the National Bankruptcy Conference, (b) lawyers who specialized in commercial law and were represented by the Commercial Law League, and (c) lawyers generally, who were represented by the American Bar Association. We will also see lawyer groups with a local tilt, such as the Dallas Bar Association and the California Bar Association, and other specialty groups, such as the American College of Trial Lawyers. Lawyers as a class had an interest in ensuring that bankruptcy reform would not diminish their role in bankruptcy proceedings, and we shall see them rally against a proposal to give a government agency the role of counseling consumer debtors. They also had an interest in enhancing the "judicial"—as opposed to the "administrative"—character of bankruptcy, because judicial proceedings require the services of people with legal training. But the interests of creditors' lawyers and debtors' lawyers clashed over the extent to which bankruptcy law should serve the interests of creditors or debtors, and the interests of local organizations and national organizations clashed over the extent to which bankruptcy law should be determined by state law or federal law.[17]

F. State and Local Authorities

Local authorities, including governors and state legislators, resist ceding authority to the federal government. One reason for this resistance is that they cannot make transfers to their supporters if they have no control over the law. Another reason is that some states can enact laws that externalize costs on other states. A third reason is simply that state officials enjoy the prestige that comes with power. Consequently, local officials often resist federal efforts to preempt state law. With respect to bankruptcy law, however, local officials are constrained by Congress' constitutional authority to enact a bankruptcy law.[18] Because Congress has all the bargaining power, local officials can retain local control only when they can give more to Congress in the form of payoffs than Congress could obtain itself through direct regulation. As we shall see, this is a possible explanation for the outcome of the battle over control of exemption policy.

G. Academics

Academics should be mentioned, since they testified frequently. It is not clear that they should be categorized as a separate interest group, however, since they appeared usually as lawyers representing various constituencies. Sometimes they simply provided information, such as statistics on bankruptcy filings and the history of bankruptcy law.

III. METHODOLOGICAL NOTES

To analyze a phenomenon as complicated as the legislative history of the Bankruptcy Code, one must make simplifying methodological assumptions. Ideally, we would like to make some assumptions about how political actors behave, on the basis of which we could make "predictions" about the content of the final law, which could be confirmed or falsified by looking at actual events. In practice, we find that the predictions are rough and the events used to test them are messy. Materials available to the researcher, like legislative history, does not necessarily reveal what happened in back rooms and over lunch. Nonetheless, the materials do allow one to adjudicate among the claims of rival hypotheses.

We assume that agents maximize utility. Creditors, debtors, lawyers, and other citizens seek legislation that transfers wealth to them. Judges and other government officials seek prestige, either for its own sake or for its effect on future income. We adopt the standard public choice view that a relatively small number of people with similar interests and a lot at stake will have more of an incentive to organize into politically effective interest groups, while larger numbers of people will have less of an incentive to form such groups. Interest groups have a disproportionate influence on the outcome of legislation, because politicians depend on their financial

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[17] The political power of lawyers has been extensively studied. *See, e.g.*, Larry E. Ribstein & Bruce H. Kobayashi, *An Economic Analysis of Uniform State Laws*, 25 J. LEGAL STUD. 131, 144 (1996).

[18] *See* U.S. CONST. art. I, 8, cl. 4.

support for reelection and because politicians depend on the information supplied by interest groups with respect to legislative proposals.[19]

But if interest group influence is disproportionate, it is not complete. Legislators maximize their utility by supporting legislation that increases their chances of reelection, but this does not imply that legislators vote only for legislation supported by the most powerful interest groups. Citizens pay attention to some issues and will vote against politicians who frequently support an interest group at the expense of the public. Politicians may need money from the interest groups, but they also need to be able to make a credible claim to voters that they vote consistently with their constituents' interests. The pressure to pay off an interest group while not alienating voters sometimes results in attempts to disguise transfers to interest groups so they cannot be easily identified as such by the voters.[20]

These assumptions produce several hypotheses at a general level: (1) when the public has little interest in an area of legislation, the legislative outcome will transfer resources from the public to interest groups; (2) when powerful interest groups conflict, the legislative outcome will reflect a compromise between them; (3) House and Senate bills will differ according to the influence of different interest groups in the jurisdictions from which members obtain their political power; (4) interest groups will seek the placement of legislative power in the level of government in a federal system in which they have the most influence; and (5) as noted above, legislators will disguise transfers when the transfers would otherwise injure the public in a visible way. These hypotheses will guide the discussion below, and will be refined in light of the evidence.

For the most part, the analysis will ignore institutional issues, such as the committee structure in Congress. Although committees are important,[21] their influence on legislation is not well understood, and the likely gain from examining their role in bankruptcy reform does not justify the increase in the complexity and length of the discussion that would be necessary.

Public-choice analysis frequently ignores ideology, arguing that interest groups seek to acquire wealth rather than vindicate ideological commitments, and members of the public, whether or not ideologically motivated, rarely have the resources or inclination to oppose the efforts of the interest groups. The assumption is useful in some contexts, but it is clearly not always true.[22] For example, as Mark Roe shows, the ideology of populism—characterized by a suspicion of concentrated economic and political power—accounts at least partly for the laws that fragment ownership of public corporations.[23] If populism has influenced corporate law, it seems likely that it also has influenced bankruptcy law.

Ideology, however, played only a minor role in the legislative history of the 1978 Bankruptcy Act. As one would expect, creditors invoked the traditions of laissez faire in this country, and certain debtor and lawyer groups invoked the tradition of providing protection to the poor. But everyone seems to have acknowledged both that credit plays an important role in the economy and should not be overly restricted, and that bankruptcy law serves as a safety net. Much of the debate was about the proper tradeoff: a technical decision made against an unquestioned ideology of welfare-state capitalism. Populist arguments did not appear in the legislative history, though no doubt they played an indirect role through their influence on the development of prior legislation.[24] There were a few desultory appeals to states' rights. It is possible that populism, states' rights, and other ideologies, such as New Deal liberalism, played a powerful role in shaping perceptions, even if they were not clearly expressed in the debates; we consider this possibility below.

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[19] The latter point, sometimes overlooked, explains why even public-spirited legislators are influenced disproportionately by interest groups. For a discussion, see MALCOLM E. JEWELL & SAMUEL C. PATTERSON, THE LEGISLATIVE PROCESS IN THE UNITED STATES 195–202 (4th ed. 1986).

[20] A survey of this literature can be found in William C. Mitchell & Michael C. Munger, *Economic Models of Interest Groups: An Introductory Survey*, 35 AM. J. POL. SCI. 512 (1991).

[21] *See, e.g.*, Heinz Eulau & Vera McCluggage, *Standing Committees in Legislatures*, in HANDBOOK OF LEGISLATIVE RESEARCH 395 (Gerhard Loewenberg et al. eds., 1985).

[22] Ideological arguments have made a comeback recently. *See, e.g.*, KEITH T. POOLE & HOWARD ROSENTHAL, CONGRESS: A POLITICAL-ECONOMIC HISTORY OF ROLL CALL VOTING (1997).

[23] *See* MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE (1994); Roe, *supra* note 5.

[24] *See* David A. Skeel, Jr., *Markets, Courts, and the Brave New World of Bankruptcy Theory*, 1993 WIS. L. REV. 465, 497–99. Skeel points to populist influence on the bankruptcy legislation of the 1930s, which transferred power from managers and lawyers to the SEC. Although Skeel argues that populism continues to be a powerful force, the 1978 Act reversed the effects of the earlier legislation.

IV. LEGAL BACKGROUND OF THE 1978 ACT

A. The 1898 Act as Amended

On the eve of the passage of the 1978 Act bankruptcy law was a complicated and arcane field. The complexity was due to many factors. The 1898 Act was itself complicated and vague, and it reflected needs produced by economic and social conditions, including a severe depression, that no longer existed in the second half of the twentieth century. Moreover, Congress had amended the 1898 Act many times, and courts had interpreted the 1898 Act and its amendments in an aggressive way, resulting in a law of bankruptcy that often bore little relation to the statutory text. By the 1960s observers were expressing a great deal of dissatisfaction with the bankruptcy system. The following sections describe the old law and the criticisms most frequently raised against it.

1. Administrative Structure

The two main players under the old bankruptcy law were the bankruptcy judge and the trustee. The bankruptcy judge—prior to 1973 officially known as the "referee" and sometimes unofficially so called up until 1978[25]—decided the disputes that arose in connection with bankruptcy cases. The referee system was controlled by the Judicial Conference of the United States and administered by the Administrative Office of the United States Courts.[26] The bankruptcy judge was appointed by panels of district judges for six-year terms. Originally, the bankruptcy judge had been considered to be a kind of clerk or "adjunct" of the district court. The district court had jurisdiction over the bankruptcy case, and although it delegated most of the decision-making functions to the bankruptcy judge, appeal from the bankruptcy judge's order was to the district court. In practice, the bankruptcy judge had a great deal of power over the day-to-day operation of the bankruptcy proceeding. The district courts would rarely conduct bankruptcy hearings themselves. The bankruptcy judge made routine decisions regarding the property in the bankruptcy estate (summary jurisdiction) and made decisions regarding property in the possession of third parties when all consented (plenary jurisdiction).[27] Some commentators argued that the bankruptcy judges did not have sufficient jurisdictional and remedial powers to decide cases in an expeditious way—they would have to refer issues outside their power to the supervising district court—and that bankruptcy judges' subordinate status weakened their authority with litigants.

The trustee was a private individual, usually a lawyer, who would represent and administer the debtor's estate. When, as frequently happened, the creditors did not elect the trustee, the trustee would be appointed by the bankruptcy judge. The trustee performed many of the functions associated with the trustee today, including those of rejecting executory contracts, operating the debtor's business, pursuing people against whom the debtor had a claim, and arguing the estate's case before the court. However, the pre-1978 bankruptcy judge often engaged in activities within the domain of the post-1978 trustee. The bankruptcy judge would, along with the trustee, attend the first creditor's meetings. As a result, the judge would hear evidence that would not be admissible at trial. The bankruptcy judge and the trustee would have frequent ex parte contact. Sometimes a bankruptcy judge would persuade a trustee to pursue a particular course of action, such as going after property, then rule on the trustee's behavior at a later hearing. Sometimes, a bankruptcy judge would actually negotiate contracts with interested parties—such as between union and management—and give business advice to a debtor in possession. The close contact between the bankruptcy judge and the trustee raised concerns that bankruptcy judges biased their decisions in favor of trustees.[28]

2. Exemptions

The 1898 Act incorporated state exemptions by reference.[29] State exemptions were rules that prevented creditors in state actions from collecting debts from debtors by

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[25] Federal judges continued to call bankruptcy judges "referees" up until 1978, *see, e.g.*, REPORT OF THE PROCEEDINGS OF THE JUDICIAL CONFERENCE OF THE UNITED STATES, SEPTEMBER 23–24, 1976, at 47–52 (1976), even though they had submitted to the pressure for the change in 1973, *see* Bankruptcy Rule 901(7) (1973). The significance of this mildly insulting practice will appear subsequently.

[26] *See Commission to Study Bankruptcy Laws, 1968: Hearings on S.J. Res. 100 Before the Subcomm. on Bankruptcy of the Senate Comm. on the Judiciary*, 90th Cong. 53 (1968) [hereinafter *1968 Senate Hearings*] (statement of Judge Edward Weinfeld).

[27] *See* H.R. REP. NO. 95–595, at 89 (1977).

[28] *See id.* at 89–91; Richard B. Levin & Kenneth N. Klee, *The Original Intent of the United States Trustee System*, NORTON BANKR. L. ADVISER, Jan. 1993, at 2, 2–3.

[29] *See* Act of July 1, 1898, ch. 541, 6, 30 Stat. 544, 548 (repealed 1978).

seizing and selling off the exempt assets. These laws exhibited striking diversity in their generosity and in the kind of property protected. The Maryland statute in 1960, for example, provided for a $100 exemption in real property, $100 in wages, insurance proceeds, and various other streams of income, and all wearing apparel, books, and tools of the trade. The Texas statute provided an exemption for a rural homestead of 200 acres of unlimited value or an urban residential and business homestead worth up to $5,000 exclusive of improvements, all furniture, wearing apparel, a large quantity of livestock, and similar items. According to one study, the average exemption claim in Maryland was $188 and in Florida was $7,427, with a national average of $943. The exemption laws differed in a variety of other ways. Many exemption statutes were archaic, singling out bibles, guns, crops, or farm animals. They reflected the rural origins of states that had since become highly urbanized. Some allowed debtors to waive the exemptions in a contract, others did not. Some allowed debtors to avoid liens, others did not. Some exemption laws had been aggressively modified through common law development, others had not. The lack of uniformity among the statutes, the obsolescence of many of them, and the unintelligibility of some of them led commentators to call for the creation of a uniform system of federal exemptions.[30]

3. Business Reorganization

On the eve of the 1978 Act, there were three forms of business reorganization—Chapters X, XI, and XII. Chapter XII was specialized and rarely used, so it will not be discussed. Chapters X and XI emerged in a loose way from two common law forms of reorganization: the equity receivership (Chapter X) and the composition (Chapter XI). Simplifying greatly, the equity receivership was a process by which the major creditors of a debtor would, often with the consent of the debtor, obtain a foreclosure and purchase its assets using a newly formed corporation of which all creditors received a share (of equity or debt). A court would appoint a receiver, usually chosen by the major creditors, and creditors could enforce their claims through this receiver. In theory, dissenting creditors were protected by the "absolute priority rule," which held that senior creditors must be paid in full before junior creditors receive any value.[31] In practice, courts circumvented this rule in order to avoid defeating reorganizations. There was generally little judicial review of the process or the plan eventually agreed to, anyway, and, as a result, creditors and commentators frequently accused managers and senior creditors of conspiring to squeeze out intermediate debt and nonmanagement equity.[32]

Compositions occurred when all creditors consented to a reorganization of the debtor's capital structure. The problem with compositions was that if any creditor declined to cooperate, that creditor either had to be paid off or the composition could not occur. Compositions generally involved the reorganization of small, closely held firms, rather than public corporations.[33]

Dissatisfaction with the common law of reorganization resulted in calls for reform and eventually in legislative amendment in the 1930s. Initial proposals were resisted by the bankruptcy bar apparently because (1) its members would lose the benefit of years of experience with the old law, and (2) the proposals would have created a centralized bureaucracy that would take business from the lawyers.[34] When the dust settled in 1938, Chapters X and XI had been created.

Chapter X, the successor of the equity receivership, created additional procedural protections. A Chapter X petition could be filed either by the creditors or by the debtors. If the judge approved the petition, he or she would appoint a trustee, who was supposed to operate the debtor's business. The trustee and the creditors could propose plans, but they had to meet elaborate requirements for disclosure of information concerning the relationships of the parties. Thanks to some aggressive interpretation by the Supreme Court, the absolute priority rule prevailed.[35] The judge

[30] The statistics and the descriptions of the statutes come from Vern Countryman, *For a New Exemption Policy in Bankruptcy*, 14 RUTGERS L. REV. 678, 681–84 (1960). *See also* Comment, *Bankruptcy Exemptions: Critique and Suggestions*, 68 YALE L.J. 1459, 1465–69 (1959). *But see* Frank R. Kennedy, *Limitation of Exemptions in Bankruptcy*, 45 IOWA L. REV. 445 (1960) (defending the old system).

[31] *See* Northern Pac. Ry. v. Boyd, 228 U.S. 482 (1913).

[32] *See* REPORT OF THE COMMN. ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 93–137, at 238–39 (1973) (quoting SECURITIES & EXCH. COMMN., REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES, pt. 8, at 24–26, 29 (1940). *See generally* John D. Ayer, *Rethinking Absolute Priority After Ahlers*, 87 MICH. L. REV. 963, 968–73 (1989).

[33] *See* Ayer, *supra* note 32, at 977.

[34] *See* H.R. Doc. No. 93–137, at 239.

[35] *See* Consolidated Rock Prods. Co. v. Du Bois, 312 U.S. 510 (1941); Case v. Los Angeles Lumber Prod. Co., 308 U.S. 106 (1939). For details, see Ayer, *supra* note 32, at 974–78.

was required to dismiss Chapter X petitions if adequate relief existed under Chapter XI. The SEC had the duty to evaluate the plan and in practice had an important role in the proceedings.[36]

Chapter XI, the successor of the composition, was intended to be used by small, closely held firms. It applied to cases in which all the debt is unsecured; the plan could not affect secured debt. The debtor alone had the power to commence proceedings in Chapter XI, and it alone could make a proposal. Judicial approval of the petition was not necessary. Creditors were supposed to be represented by a creditors' committee, but the latter was often dominated by the more powerful creditors. The plan did not have to satisfy the absolute priority rule; it could be confirmed as long as creditors would receive no less under the plan than they would receive from liquidation. The SEC had no role in Chapter XI.[37]

Chapter X and XI proceedings evolved in ways not foreseen by the drafters. Although, as noted, the drafters intended Chapter XI for close corporations and Chapter X for public corporations, they did not put rules reflecting these intentions in the statute. Debtors of both kinds preferred Chapter XI, and helped along by a controversial Supreme Court case,[38] usually succeeded in reorganizing under Chapter XI, despite the SEC's time-consuming efforts to convert to Chapter X. By the eve of the 1978 Act, Chapter XI had become the dominant form of reorganization.

The benign interpretation of this development is that Chapter XI proved to be more flexible than Chapter X; the skeptical interpretation, as we will see, is that Chapter XI gave certain powerful interests—managers, managers' lawyers, large creditors—advantages during reorganization. One's choice between the two interpretations would probably depend on how one judged the performance of the SEC. The SEC routinely exercised its right to intervene and be heard on Chapter X matters, participated in meetings and conferences, challenged the qualifications of trustees, attacked the representation of interests on creditors' committees, scrutinized the trustee's administration of the estate, challenged attempts to sell the debtor's property, opposed plans of reorganization that did not adhere to the absolute priority rule, and criticized compensation arrangements.[39] These interventions were time consuming, and they were considered a nuisance by those who sought to push through a reorganization plan. But they may also have protected bondholders and equityholders who did not have a large enough stake to participate in the reorganization. The main disadvantage of Chapter XI—that debtors could not modify the rights of secured creditors—was overcome through common law development. A stay would prevent secured creditors from repossessing collateral until the debtor had negotiated a plan with the unsecured creditors, after which the debtor could pay off the secured creditor. The debtor did not have to compensate the secured creditor for the lost opportunity to use the collateral and so had leverage with which to extract concessions from the secured creditor.

There were other problems with Chapters X and XI, including most prominently the lengthy litigation that was necessary to resolve the question of which chapter was appropriate. After a debtor filed under Chapter XI, the SEC would sometimes raise this question by moving for conversion to Chapter X. Determining which chapter applied was difficult because of the vague "as needed" test created by the Supreme Court.[40] This benefited the debtor and its management, because they could use the threat of delay and the consequent diminution in the value of assets that could satisfy the creditors' claims to obtain concessions from the creditors. Dissatisfaction with the complexity and manipulability of reorganization law led to calls for reform.

4. Miscellaneous

Under the "miscellaneous" category we gather several issues that were not as important as administrative structure, exemption policy, and reorganization but that nonetheless received a great deal of attention during the legislative history of the 1978 Act. The first issue concerned whether debtors could too easily discharge educational loans, in effect converting the federal loan programs into tuition subsidies. The second issue concerned the practice of reaffirmation. Debtors frequently prom-

[36] *See* H.R. DOC. NO. 93–137, at 240–46.

[37] *See id.*

[38] *See* General Stores Corp. v. Shlensky, 350 U.S. 462 (1956).

[39] *See* Michael E. Hooton, *The Role of the Securities and Exchange Commission Under Chapter X, Chapter XI and Proposed Amendments to the Bankruptcy Act*, 18 B.C. INDUS. & COM. L. REV. 427 (1977).

[40] *See Shlensky*, 350 U.S. at 466. *Shlensky* rejected the view that Chapter XI is unavailable to large public corporations, holding instead that the propriety of Chapter XI depends on the "needs" of the debtor. The choice between chapters thus always would be a fact-sensitive inquiry.

ised to pay prebankruptcy debts in return for postbankruptcy credit from the same creditor. Commentators argued that this practice undermined bankruptcy's fresh-start goal. The third issue was whether shady creditors manipulated the fraud exception to discharge—under which discharge was denied if the debtor had made a fraudulent statement to creditors—with the result that many debtors could not obtain the fresh start they deserved. The argument was that creditors would have debtors fill out confusing forms with the intention of causing debtors to fail to list all their assets and liabilities. This would constitute fraud, resulting in a denial of discharge.

B. Legislative History of the 1978 Act

The legislative history of the Bankruptcy Reform Act is complex.[41] It consists of thousands of pages of hearings, reports, and debates spanning a decade. To simplify the analysis, we divide the legislative history into three stages. The first stage extends from the enactment of the law creating a bankruptcy commission in 1968 to the commission's release of a report and proposed bill in 1973. The second stage extends from the House and Senate hearings on the commission's bill and on an alternative proposed by a group of bankruptcy judges, mainly in 1975 and 1976, to the passage of House Bill 8200 and Senate Bill 2266 in 1978. The third stage covers the resolution of the conflicts between House Bill 8200 and Senate Bill 2266, leading to enactment of the Bankruptcy Reform Act in November, 1978. A brief description of these events sets the stage for the analysis and foreshadows many of its themes.

1. Stage 1

Growing dissatisfaction with the bankruptcy laws in the 1960s persuaded first a subcommittee of the Senate Judiciary Committee and then the full Congress to create a commission to evaluate the bankruptcy laws. The original Senate bill provided that the commission would consist of representatives from the House and Senate, three bankruptcy judges, and three businessmen.[42] Apparently in response to objections from the federal judiciary to the presence of bankruptcy judges and the absence of Article III judges,[43] the House version of the bill provided for three presidential appointees, two representatives from the House, two representatives from the Senate, and two appointees of the Chief Justice of the Supreme Court. This version passed the full Congress in 1968.[44]

The Commission on the Bankruptcy Laws of the United States was formed in 1971 and met over the next two years. In 1973 the Commission issued a report criticizing the existing bankruptcy laws and proposing a legislative replacement known as the Commission's Bill, or CB.[45] The Commission listed the following complaints about the bankruptcy laws:

1. The rapid increase of bankruptcies from 10,196 in 1946 to 208,329 in 1967, and especially of consumer bankruptcies.[46]
2. Administrative waste. For example, in 1972 $6.7 million of the $17 million spent on the operation of bankruptcy courts was spent on no-asset cases.[47]
3. Insufficiently generous fresh start for debtors, and inadequate incentives for creditors to collect in bankruptcy.[48]
4. Lack of uniformity in the treatment of debtors.[49]

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[41] For a detailed synopsis of the legislative history, see Kenneth N. Klee, *Legislative History of the New Bankruptcy Code*, 54 AM. BANKR. L.J. 275 (1980). *See also Congress Approves New Bankruptcy System*, 34 CONG. Q. ALMANAC 179 (1978). This section relies on these articles, as well as on the original statutory sources.

[42] *See* S.J. Res. 100, 90th Cong., 2(a) (1968).

[43] *See 1968 Senate Hearings, supra* note 26, at 53–55, 63–65 (statement and testimony of Judge Edward Weinfeld).

[44] The Commission was created by the Law of July 24, 1970, Pub. L. No. 91–354, 84 Stat. 468 (eliminated 1973); for the hearings that led to this law, see *Bankruptcy: Hearings on S.J. Res. 88, H.R. 6665, & H.R. 12250 Before Subcomm. No. 4 of the House Comm. on the Judiciary*, 91st Cong. (1969); *1968 Senate Hearings, supra* note 26. The Commission and other participants were influenced by STANLEY ET AL., BANKRUPTCY: PROBLEM, PROCESS, REFORM (1971).

[45] The CB was drafted by Frank Kennedy and his staff on the Commission. *See* FRANK R. KENNEDY, THE ORIGINS AND GROWTH OF BANKRUPTCY AND REORGANIZATION LAWS IN THE 20TH CENTURY: AN ORAL HISTORY PERSPECTIVE 49–51 (1994).

[46] *See* H.R. DOC. NO. 93–137, at 2 (1973).

[47] *See id.* at 3. It should be noted that this statistic may not actually indicate waste but just that a large number of cases were no-asset cases.

[48] *See id.* at 3–4.

[49] *See id.* at 4.

5. Abusive or negligent practices by bankruptcy judges, trustees, and bankruptcy lawyers.[50]

The CB contained many modifications of the bankruptcy system, but three stood out. First, it provided for a sharper distinction between bankruptcy judges and trustees, elevating the status of the bankruptcy judges and placing the trustees in a new, centralized bankruptcy agency in the executive branch.[51] Second, it provided for a system of uniform federal exemptions.[52] Third, its reorganization provisions consolidated Chapters X, XI, and XII and modified the procedural and substantive rules of confirmation.[53]

Infuriated by their exclusion from the Commission and suspicious of its capacity to produce an adequate bill, the bankruptcy judges created their own bill, known as the Judges' Bill, or JB. The CB and the JB had many similarities but several important differences.[54] The bankruptcy judge under the JB was to have more power and status than the bankruptcy judge under the CB, and the JB did not provide for a bankruptcy agency. The JB provided for minimum, rather than uniform, federal exemptions. Although both bills had special provisions for publicly held corporations, the JB, unlike the CB, would have maintained separate tracks for close corporations and public corporations.

2. Stage 2

Representatives Don Edwards and Charles Wiggins introduced the CB in 1973, but little was accomplished that year. In 1974 Edwards and Wiggins reintroduced the CB as House Bill 31 and the JB as House Bill 32 and during 1975 and 1976 held lengthy and detailed hearings on them before the Judiciary Committee's Subcommittee on Civil and Constitutional Rights.[55] These hearings culminated in House Bill 6, which was introduced in 1977. The Subcommittee held meetings on House Bill 6, which resulted in a new version, House Bill 7330, and after further discussions yet another version, House Bill 8200. The Judiciary Committee amended House Bill 8200 and issued a new version, along with a committee report.[56] Meanwhile, the Subcommittee also prepared a report on the constitutionality of the proposed bankruptcy courts.[57] The House debated and amended House Bill 8200 in October 1977, but because the legislative managers did not approve of this amendment—a similar one had been rejected by the Subcommittee—they removed the bill from the calendar. The Subcommittee held further hearings[58] and released a new report.[59] The House debated House Bill 8200 again in February 1978, reversed the earlier amendment, and passed the bill by a voice vote.[60]

The 1977 House Report identified three major problems with the bankruptcy system: (1) impaired adjudication of cases resulting from judges' lack of independence and low status; (2) insufficient relief to consumer debtors; and (3) excessive vagueness.[61] To address these and other problems, House Bill 8200 proposed the following changes to the law.

Administrative structure. House Bill 8200 would have abolished the old referee system. It would have given the new bankruptcy judges full powers of law, equity, and admiralty, including injunctive powers, the power to hold jury trials, contempt power, and jurisdiction over all matters arising in connection with a bankruptcy case, with appeal to the circuit courts. The bill also would have given bankruptcy

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[50] *See id.*

[51] *See id.* at 6–8.

[52] *See id.* at 11.

[53] *See id.* at 28. The Commission also made a large number of proposals regarding the mechanics of bankruptcy and the rights of the parties in bankruptcy; it also made proposals regarding railroad reorganizations and wage-earner plans. *See id.* at 9–31.

[54] The bills are printed and compared in *Bankruptcy Act Revision: Hearings on H.R. 31 and H.R. 32 Before the Subcomm. on Civil and Constitutional Rights of the House Comm. on the Judiciary*, 94th Cong. app. (1975–1976) [hereinafter *1975–76 House Hearings*].

[55] *See 1975–76 House Hearings.*

[56] *See* H.R. REP. NO. 95–595 (1977).

[57] *See* STAFF OF THE SUBCOMM. ON CIVIL AND CONSTITUTIONAL RIGHTS OF THE HOUSE COMM. ON THE JUDICIARY, 95TH CONG., CONSTITUTIONAL BANKRUPTCY COURTS (Comm. Print No. 3, 1977) [hereinafter 1977 HOUSE SUPP. REPORT].

[58] *See Bankruptcy Court Revision: Hearings on H.R. 8200 Before the Subcomm. on Civil and Constitutional Rights of the House Comm. on the Judiciary*, 95th Cong. (1977) [hereinafter *1977 House Supp. Hearings*].

[59] *See* SUBCOMMITTEE ON CIVIL AND CONSTITUTIONAL RIGHTS OF THE HOUSE COMM. ON THE JUDICIARY, 95TH CONG., REPORT ON HEARINGS ON THE COURT ADMINISTRATIVE STRUCTURE FOR BANKRUPTCY CASES (Comm. Print No. 13, 1978) [hereinafter 1978 HOUSE REPORT].

[60] The main members of staff who worked on and drafted the 1978 Act were Kenneth Klee and Richard Levin, on the House side, and Robert Feidler and Harry Dixon, on the Senate side.

[61] See H.R. Rep. No. 95–595, at 4.

judges more control over local rulemaking, finances, and so on, so they would not have to defer to district judges, which was considered demeaning. Bankruptcy judges would have become Article III judges, with full tenure and advice-and-consent presidential appointment.[62] In addition, the bill would have created a system of U.S. Trustees, modeled on the U.S. Attorney system. Trustees would have been autonomous but under the loose supervision of the Department of Justice. They would have had administrative authority over bankruptcy cases.[63]

Exemptions. House Bill 8200 provided for a $10,000 exemption for the homestead and $5,000 for personal property, among other things, but would have given the debtor the right to choose between the federal and state exemptions—effectively making the federal exemptions a floor. House Bill 8200 would also have given the debtor the right to waive judicial liens on exempt property and nonpurchase money security interests in household-related exempt property.[64] House Bill 8200 would have allowed consumer debtors to redeem collateral.[65]

Business reorganizations. House Bill 8200 provided for the consolidation of the old Chapters X and XI, and it chose as the standard for approval of confirmations a substantially more liberal rule than the one that prevailed under Chapter X. The debtor would have had an exclusive 120-day right to propose a plan. The management would presumptively have retained control as the debtor in possession. The CB, in contrast, made the *trustee* presumptive for large, public corporations. Creditors' committees would have been appointed by the courts.[66]

Miscellaneous. House Bill 8200 retained the discharge exception for false financial statements. Because it was believed that creditors sometimes manipulate debtors, however, if a creditor made this charge but then lost, it had to pay debtors' costs and attorneys' fees.[67] Over significant objections,[68] the bill retained the discharge for educational loans.[69] The bill would have prohibited reaffirmations.[70]

Meanwhile, in the Senate the CB and the JB had been introduced as Senate Bill 236 and Senate Bill 235 in 1975. The Senate Judiciary Committee's Subcommittee on Improvements in Judicial Machinery conducted hearings.[71] No further activity occurred until 1977, when a new bill, Senate Bill 2266, was proposed and hearings were held.[72] After the House passed House Bill 8200, the Subcommittee revised Senate Bill 2266 and reported it out to the Judiciary Committee. The Judiciary Committee voted in favor of the new Senate Bill 2266 after amending it, and a report was filed.[73] After Senate Bill 2266 traveled through several committees, it came before the full Senate, which amended it and passed it by a voice vote as an amendment in the nature of a substitute to House Bill 8200. Senate Bill 2266 included the following provisions.

Administrative structure. Senate Bill 2266 would have created less powerful and prestigious bankruptcy judges than House Bill 8200. Bankruptcy judges would have continued as adjuncts of the district courts. Bankruptcy judges would have been appointed by the court of appeals for each circuit, rather than by the President, and would have had a twelve-year term.[74] Senate Bill 2266 also would not have created a bankruptcy agency in the executive branch, instead keeping the trustee system in the judicial branch.[75]

Exemptions. Senate Bill 2266 followed old law and provided for the incorporation of state exemptions.[76]

Business reorganization. Senate Bill 2266 would have consolidated Chapters X, XI, and XII, but it left a separate track for public corporations. Among other things, it provided for mandatory appointment of a trustee in the case of public corporations. It would have retained the old, strict standard for reorganization of public cor-

[62] *See id.* at 7.
[63] *See id.* at 88.
[64] *See id.* at 126.
[65] *See id.* at 127.
[66] *See id.* at 220–31.
[67] *See id.* at 128–31.
[68] *See id.* at 536–38 (supplemental views of Rep. Ertel).
[69] *See id.* at 132–34.
[70] *See id.* at 365–66.
[71] *See The Bonkruptcy Reform Act: Hearings on S. 235 and S. 236 Before the Subcomm. on Improvements in Judicial Machinery of the Senate Comm. on the Judiciary*, 94th Cong. (1975) [hereinafter *1975 Senate Heorings*].
[72] *See Bankruptcy Reform Act of 1978: Hearings on S. 2266 & H.R. 8200 Before the Subcomm. on Improvements in Judicial Machinery of the Senate Comm. on the Judiciary*, 95th Cong. (1978) [hereinafter *1977 Senate Heorings*] (taking place on Nov. 28–29 and Dec. 1, 1977).
[73] *See* S. REP. NO. 95–989.
[74] *See id.* at 17–18.
[75] *See id.* at 4.
[76] *See id.* at 6.

porations, while providing for a standard similar to the House's for the reorganization of private corporations.

Miscellaneous. Senate Bill 2266 would have retained the fraud exception to discharge but provided that the debtor is entitled to attorneys' fees and costs if the creditors' claim of fraud is not brought in good faith.[77] Student loans would have been nondischargeable for five years after they were due.[78] Debtors would have had thirty days to rescind a reaffirmation, but after the expiration of that period reaffirmations would have been enforceable.[79]

3. Stage 3

Stage 3 began with an impasse. Congress faced two bills, House Bill 8200 as originally passed by the House and Senate Bill 2266, though the latter was now known as House Bill 8200 as amended by the Senate ("first Senate amendment"). Instead of holding a joint conference, the managers of the legislation conducted negotiations and hammered out a deal. The compromise was reflected in the House's amendment to House Bill 8200, passed in September 1978. In October the Senate passed the House amendment by a voice vote after adding several of its own amendments ("second Senate amendment"). The House concurred, also by a voice vote, and the President signed the bill in early November.

The House amendment split the differences between House Bill 8200 and Senate Bill 2266 in several ways. The House prevailed on the transfer of new powers to the bankruptcy judge, but the bankruptcy judge would not be an Article III judge. The Senate prevailed in its efforts to prevent the creation of a bankruptcy agency in the executive branch, but agreed to a limited pilot program to test the idea. The compromise created a uniform system of federal exemptions—for example, a $7,500 homestead exemption—but gave the states the right to opt out. It adopted the House's version of reorganization law, with two concessions to the Senate: it included vague provisions designed to create some special protections for cases involving public corporations, and it provided for the automatic appointment of an examiner in such cases, though not of an independent trustee as the Senate had preferred. Reaffirmations were to be permitted, but they had to meet disclosure and related requirements. Numerous other compromises occurred, but we need not detail them.[80]

The provisions of the second Senate amendment are strikingly trivial, but their triviality makes them all the more interesting. The amendment reduced the bankruptcy judges' authority to hire clerks, gave the Judicial Council the power to issue "recommendations" of candidates for the appointment of bankruptcy judges, eliminated the bankruptcy judges' retirement plan, gave the chief judge of a circuit the power to evaluate certain incumbent bankruptcy judges, and even possibly, obscurely, took away the bankruptcy judges' hard-won right to be called "judge" rather than "referee."[81] Because of the lateness of the date, the House passed the second Senate amendment without making further changes.

The second Senate amendment is surprising not only because its provisions were trivial, but also because it seems to have violated the deal made between the House and the Senate. As we shall see, the evidence suggests that Senator DeConcini unilaterally made these changes and told the House that they were non-negotiable. Rep. Edwards was distressed about these changes but could not oppose them at the late date. The House passed the second Senate amendment in early October; the President signed the bill in early November.[82]

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[77] *See id.*

[78] *See id.* at 79.

[79] *See id.* at 80–81.

[80] For a description of the compromises, see 124 Cong. Rec. 33,992–4,018 (1978) (statement of Senator DeConcini). Apparently, there were hundreds of points of disagreement, but the conflicts over administrative structure and corporate reorganization generated the most heat. See Telephone Interview with Robert Feidler, Former Counsel to the Senate Judiciary Committee (Jan. 13, 1997) [hereinafter Feidler Interview].

[81] *See* 124 CONG. REC. 34,144–45 (1978) (statement of the Hon. Don Edwards).

[82] Apparently, the bill was held up by the Speaker of the House because either he or powerful representatives wanted to prevent the reappointment of a certain bankruptcy judge in Connecticut. The transition provisions provided that all sitting judges at the time of enactment would be automatically reappointed; the Connecticut judge's term expired after the House voted and before the President signed. *See* Telephone Interview with Kenneth N. Klee, Former Associate Counsel to the House Judiciary Committee (Jan. 29, 1997) [hereinafter Klee Interview]; *see also* Feidler Interview, *supra* note 80.

V. ADMINISTRATIVE STRUCTURE

Participants in the hearings came into conflict over two major issues of administrative structure. The first issue concerned the power and status of the bankruptcy court. Some participants believed that bankruptcy judges should have broader powers than those they enjoyed under the old law and that they should have greater status; other participants preferred the old law. Because the status of a judge depends in part on the extent of his powers, the questions of power and status were intertwined. The second issue concerned the nature of the administrative apparatus that would control the appointment of trustees. Some participants wanted to create a "bankruptcy agency" in the executive branch; other participants wanted to keep the appointment of trustees in the judicial branch.

Recall that the Senate bill to create a Bankruptcy Commission contemplated that bankruptcy judges would serve on the Commission, but that the final law created slots only for appointments from the executive branch, the Senate, the House, and the federal judiciary. The bankruptcy judges' exclusion from the Commission resulted from the objections of the federal judiciary. During the initial hearings before the Senate in 1968 Judge Weinfeld, speaking for the Judicial Conference of the United States, said:

> Here the proposal is that referees be included as well as lawyers, but the fact is that the ultimate judgment with respect to bankruptcy matters is made by judges of the court who review the various actions of referees when petitions for review are presented.
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> . . . You must bear in mind that the experts [i.e., referees] have points of view reflecting at times their separate interest—I don't mean this special interest in any invidious sense—but men sometimes become wedded to their particular ideas. It would seem to me that the Commission that we propose [i.e., without referees] would be more concerned with broad-gaged policies. . . .[83]

Weinfeld's argument was flimsy. No doubt bankruptcy judges had a "separate interest," but so did everyone else involved in bankruptcy reform. Bankruptcy judges knew more than anyone else about the bankruptcy system, and the oddity of excluding them from the Commission was obvious enough to others—no testifying party outside the federal judiciary seconded Weinfeld's views.[84] But his views nonetheless prevailed.[85]

The most likely reason that the federal judiciary opposed the participation of bankruptcy judges on the Commission is that it feared that bankruptcy judges would use their influence on the Commission to press for a bankruptcy law that would transfer power and status from the federal judiciary to the bankruptcy judges. Bankruptcy judges had long made clear to the federal judiciary their dissatisfaction with their subordinate status, lobbying the federal judges for more autonomy, fancier titles, greater privileges, and the right to participate in judicial policymaking and administration. They felt most keenly their exclusion from the Judicial Conference, the judicial branch's policymaking body. Judge Weinfeld did not admit the motives of the federal judges, of course; but we will see shortly evidence that the federal judiciary's most passionate concern about bankruptcy reform was that the status of federal judges would be diluted by an increase in the power of bankruptcy judges. The House and Senate yielded to the federal judges' objections to the participation of bankruptcy judges on the Commission,[86] probably because they believed that the success of any legislative deal would depend on the judges' cooperation both during legislation and when the statute entered litigation.

The federal judges' victory was short lived. The Commission argued that bankruptcy judges' low status hampered their efforts to adjudicate bankruptcy disputes in a fair and expeditious manner. The solution to this problem was "to enhance the real and apparent judicial independence of bankruptcy judges."[87] One route to enhancement would occur through modification of appointment, tenure, and compensa-

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[83] *See 1968 Senate Hearings*, *supra* note 26, at 63 (testimony of Judge Edward Weinfeld).

[84] For a rejoinder from a bankruptcy judge, see *1975–76 House Hearings*, *supra* note 54, at 229–34 (reprinting Conrad K. Cyr, *Setting the Record Straight for a Comprehensive Revision of the Bankruptcy Act of 1898*, 49 AM. BANKR. L.J. 99, 103–08 (1975)).

[85] Justice Burger was entitled to fill his slots with bankruptcy judges, but he resisted the pressure of the bankruptcy judges to do so and appointed two federal district judges. *See* KENNEDY, *supra* note 45, at 47.

[86] It is generally understood that the House and Senate changed the representation on the Commission in order to appease the federal judges rather than for some other purpose. *See* Feidler Interview, *supra* note 80.

[87] H.R. DOC. NO. 93–137, at 95 (1973); *see also* KENNEDY, *supra* note 45, at 52 (observing that the CB "elevated the stature and the prestige of the [bankruptcy] court and assimilated the procedures to the procedures of the federal district court").

tion. The CB would have made bankruptcy judges subject to presidential appointment with the advice and consent of the Senate, increased their tenure from six to fifteen years, and increased their compensation. The other route to enhancement of status would occur through modification of the role of the bankruptcy judge, so that the judge would have fewer "administrative" and more "judicial" responsibilities—the theory being that administrative actions dissipated the cloud of impartiality that otherwise enhanced the prestige of the judge. In pursuit of these aims the CB would have reduced bankruptcy judges' administrative responsibilities, expanded their jurisdiction, and increased their remedial powers.[88]

Judge Weinfeld—now on the Commission—rejected the Commission's argument in a separate statement and maintained that the existing system worked adequately, that bankruptcy judges' powers should not be changed, and that the appointment process should remain in the hands of the district judges, although perhaps tenure should be increased to twelve years.[89] He lost on all these issues. However, he and the other judge on the Commission, Hubert Will, prevailed on the other members of the Commission not to propose that the bankruptcy judgeship be made an Article III position.[90]

Before identifying the sources of this conflict, let me mention the Commission's second major proposal regarding administrative reform. The Commission proposed the establishment of an entirely new independent agency in the executive branch, to be called "The United States Bankruptcy Administration." The Administrator would be a presidential appointee, with the advice and consent of the Senate, and would have a seven-year term. The Administration would take over the functions of the trustee and the administrative functions of the bankruptcy judge, and it would offer counseling services to debtors in consumer cases.[91] Judge Weinfeld did not object to this proposal in his statement, but later, during the hearings, the federal judges and the bankruptcy judges would object to it.

Why did the majority of the Commission support the enhancement of the independence and prestige of the bankruptcy courts, while Judge Weinfeld opposed it? Why did the Commission support the creation of a bankruptcy agency while the bankruptcy judges opposed it? Looking beyond the parties' statements and at their interests, it appears that the proposed administrative structure reflected concerns about maintaining and expanding power, especially the power of patronage.

Seven of the nine members of the Commission came from the executive and legislative branches, both of which had an interest in creating new patronage opportunities. The bankruptcy courts described in the CB would have served this interest by (1) transferring the appointment power from the judicial branch to the legislative and executive branches, and (2) making the position of bankruptcy judge more attractive to candidates and thus a more valuable currency for repaying political debts. The creation of a bankruptcy agency would have served the executive and legislative branches' interest in patronage opportunities by creating one advice-and-consent position and countless subsidiary positions, to be filled by political allies.

The federal judges opposed the creation of more independent bankruptcy courts, because (1) they would lose their appointment power over bankruptcy judges, and thus one of their main patronage opportunities, and (2) their status would be diluted through the vast increase in the number of federal judicial positions. The federal judges also opposed the creation of the bankruptcy agency, because to the extent that the agency would deprive bankruptcy judges of the power to appoint trustees and to the extent to which the bankruptcy judges were within the control of the federal judges, the creation of the bankruptcy agency would reduce the power and independence of the judiciary.

The bankruptcy judges supported the enhancement of the power and prestige of the bankruptcy courts, because they would gain power, status, and possibly pecuniary compensation. Bankruptcy judges had for a long time complained about what they saw as their low status,[92] and they saw bankruptcy reform as an opportunity

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[88] *See* H.R. Doc. No. 93–137, at 85–96.

[89] *See id.* at 299–301 (separate statement of Judge Edward Weinfeld).

[90] *See* Kennedy, *supra* note 45, at 52.

[91] *See* H.R. Doc. No. 93–137, at 117–53.

[92] *See 1977 House Supp. Hearings, supra* note 58, at 227–28 (testimony of Attorney General Bell); *1975–76 House Hearings, supra note 54, at 539 (statement of Harold Marsh, Jr., Former Chairman, Commission of Bankruptcy Laws of the United States, claiming that bankruptcy judges "resent their status as being subordinated to and dependent upon the Federal District Court"). Here is an example of the issues at stake:*

> We think that it is demeaning and unbecoming for a district judge to enact a local rule requiring that any fee in excess of a rather minimal amount, $200, must be passed be-

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to solve this problem. Said one observer about the JB: "I think the Judges' bill is the result of the fact that these are judges and they want to be judges and judges' judges and this accounts for what is in the Judges' bill, the need for status."[93] Although the CB would not have enhanced the bankruptcy judges' status and power as much as the JB—in particular, the latter would have made appeal to the circuit court, bypassing the district court, in effect treating bankruptcy courts and district courts as equals[94]—it did enough to garner the bankruptcy judges' support in this respect.

The bankruptcy judges, however, opposed the creation of the bankruptcy agency. One judge testified:

> My view is that a national corporate trustee will be the framework for another huge bureaucracy with tentacles reaching into every area of the country and marked with all the weaknesses of inept officialism, expensive red tape and corruption inducing proliferation [sic]. This last consideration is vital for the temptation and the opportunity for corruption will be unlimited.[95]

A more plausible explanation for the bankruptcy judges' opposition to the bankruptcy agency is that the latter would have deprived them of *their* main source of patronage—the power to appoint trustees from their acquaintances in the local bankruptcy bar.[96] As a bankruptcy judge (and his clerk) wrote after the enactment of the bankruptcy bill, "Judicial appointment of a trustee is common, particularly in nominal asset cases filed by individual debtors. The court-appointed trustee is often understandably a personal friend of the judge who serves in a number of cases before that judge at a given time."[97] The bonds of friendship are strong indeed.

If the patronage motives were half hidden in the Commission Report and related documents, they became clearer during the hearings in Stage 2. The federal judges, who had earlier resisted the bankruptcy judges' efforts to have their title changed from "referee" to "bankruptcy judge," apparently on the grounds that such a change

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> fore the district judge for approval before it can be allowed, remembering that he has had nothing whatsoever to do with this case.
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> . . . If there is a major, serious contempt that involves something more and requiring something more than a fine of $200, it has got to be transferred and certified to a district judge. We feel that is totally inappropriate and tends to weaken the respect that litigants and lawyers should entertain for the bankruptcy court.

1975–76 House Hearings, *supra* note 54, at 153 (testimony of Bankruptcy Judge Robert B. Morton, President, National Conference of Bankruptcy Judges). Here is another:

> While H.R. 31, the Commission Bill, strongly favors the elevation and independence of the new court there is one aspect of their proposal that is seriously flawed and, in fact, works against their own goal of enhancing the status and dignity of the new court. I refer to the H.R. 31 provision that *clerks of the bankruptcy court be appointed from among the clerks of the district court with the concurrence of the district judges*. That kind of hybridization would be as damaging as it is unnecessary and inconsistent. Any independent court worthy of the name must have a clear, unblurred line of authority to its own clerks.

Id. at 513 (statement of Bankruptcy Judge Robert B. Morton) (footnote omitted). Here is a third:

> [T]he bankruptcy referees were certainly regarded at a different level from district judges [during the early post-World War II years]. In my early visits for meetings at Foley Square, the referees did not sit at tables with the district judges and, I believe, did not ride the same elevators. My recollection is that the referees didn't even have their names on their doors, but I'm not positive about that.

KENNEDY, *supra* note 45, at 32–33.

[93] *1975–76 House Hearings*, *supra* note 54, at 869 (testimony of Phillip Shuchman, Law Professor, University of Connecticut) (emphasis added).

[94] The CB would have made the bankruptcy judge a presidential appointment, whereas the JB would have kept the appointment of the bankruptcy judge within the judicial branch. The CB's provision thus would have given power to the executive branch and the Senate; the bankruptcy judges may have believed that they had more influence over judicial appointments, or else they were trying to mollify the federal judges. The JB also would have expanded some of the administrative powers placed within the judicial branch. *See 1975–76 House Hearings*, *supra* note 54, at app.

[95] H.R. DOC. NO. 93–137, at 112 (quoting Bankruptcy Judge Asa S. Herzog); *see also* Levin & Klee, *supra* note 28, at 3.

[96] Such patronage—or at least its "appearance"—was widely acknowledged. *See, e.g., 1977 Senate Hearings*, *supra* note 72, at 1082 (statement of Margerie Girth, Law Professor, State University of New York at Buffalo, and David T. Stanley, consultant); H.R. REP. NO. 95–595 , at 92 (1977) ("Some judges view the trustee's job as a patronage position for tho bankruptcy judge to dispense; the judge may even let it be known that elections are not viewed with favor."); 124 CONG. REC. 32,419 (1978) (remarks of Rep. Butler).

[97] John J. Galgay & Kenneth H. Eckstein, *Case Administration Under the Bankruptcy Reform Act: The United States Trustee Program*, *in* ANNUAL SURVEY OF BANKRUPTCY LAW 151, 152 (William J. Norton, Jr. ed., 1979) (footnote omitted).

would dilute the prestige of the title "judge,"[98] reiterated their opposition to elevation of the bankruptcy judges and to the creation of a bankruptcy agency.[99] Again, the federal judges could not admit that their motive was a fear of a loss of prestige, but a former judge made this rationale explicit:

> [A] significant increase in the number of Article III judges, contemplated by [House Bill 8200], would dilute the significance, and prestige, of district judgeships. Prestige is a very important factor in [*80] attracting highly qualified men and women to the federal bench, from more lucrative pursuits.
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> . . . .
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> . . . The benefits which might flow from increasing the prestige of that post [of bankruptcy judge] would be far outweighed by the dangers brought by a loss of prestige of federal district judgeships.[100]

In addition to the evidence that the judges feared losing status, there emerged evidence that they feared losing the patronage power to appoint bankruptcy judges.[101] One must admit the possibility that the federal judges were right on policy grounds, but if they had been, one would have expected some support for their views from outside the judicial branch. Almost no one—creditors, debtors, or lawyers—expressed such support.[102]

Stage 2 also saw the bankruptcy judges reiterating their support for higher status bankruptcy courts and their opposition to the creation of a federal bankruptcy agency.[103] Evidence of the bankruptcy judges' practice of appointing cronies to the position of trustee supports the hypothesis that the bankruptcy judges opposed the bankruptcy agency because they feared losing their patronage power. Some observers suggested the existence of a "bankruptcy ring," consisting of the local bankruptcy bar and bankruptcy judges who favored each other over outsiders.[104] The

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[98] This is generally known, hut there is a reference to the controversy in *1977 House Supp. Hearings, supra* note 58, at 192–93 (testimony of Judge David Kline, President, National Conference of Bankruptcy Judges).

[99] *See 1977 House Supp. Hearings, supra* note 58, at 112–17 (statement of Judge Wesley E. Brown, Judicial Conference); *id.* at 128–32 (statement of Judge Edward Weinfeld, Judicial Conference); *id.* at 154–58 (response of Judge Wesley E. Brown to list of questions); *1975–76 House Hearings, supra* note 54, at 5–6, 14–173 (statement and testimony of Berkeley Wright, Chief, Bankruptcy Division, Administrative Office of the U.S. Courts); *id.* at 20–21 (H. Kent Presson, Assistant Chief, Bankruptcy Division, Administrative Office of the U.S. Courts). The third document shows the judges seeking to keep the bankruptcy judges' powers and employment benefits below those of Article III district judges in every way: from a lower salary to denial of membership in the judicial conference. *Cf. 1977 Senate Hearings, supra* note 72, at 413 (testimony of Judge Ruggero J. Aldisert) (observing that all judges who considered this question (two circuits did not) unanimously opposed Article III status for bankruptcy courts: "I would like to emphasize . . . that it is very unusual to get a group of federal judges to agree on anything. . . . But I think it is very significant that . . . there was unanimity in the Judicial Conference. . . ."). It is important to emphasize that Justice Burger was not acting on his own, as is sometimes claimed, hut was acting on behalf of the entire federal judiciary. *See* Ruggero J. Aldisert, *The Judicial Conference and the New Bankruptcy Act*, 65 A.B.A. J. 229 (1979).

[100] *1977 House Supp. Hearings, supra* note 58, at 9 (statement of former (district) Judge Simon H. Rifkind).

[101] Consider the following exchange:

> Mr. McClory. One very good reason why district judges don't want to change the system, I think we must recognize, is that they enjoy appointing the referees, and they enjoy appointing special masters, too.
> Judge Rifkind. Maybe they do.

1977 House Supp. Hearings, supra note 58, at 50; *see also 1977 Senate Hearings, supra* note 72, at 514–15 (testimony of Stanford Lerch, former Trustee).

[102] The major exception is the Attorney General. *See infra* text accompanying notes 117–21.

[103] *See, e.g., 1975–76 House Hearings, supra* note 54, at 512–16 (statement of Bankruptcy Judge Robert B. Morton).

[104] According to one report:

> As a result of the nature of the system itself, there exists a relationship between the Bankruptcy Judges, the trustees and the counsel for the trustees which many people, including many involved in the system, consider unhealthy from the point of view of proper judicial and governmental administration. The judges by and large appoint the trustees and therehy in effect select the counsel. They do not generally appoint persons who are total strangers to them, and it would be entirely unrealistic to expect that they would or should. These same trustees and lawyers then deal on a day-to-day basis with the judge regarding the routine conduct of the proceeding, and finally these same trustees and lawyers appear before the judge as litigants and counsel when a controversy arises.
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> As a result of the conditions discussed above, and I am sure for other reasons, there grew up over the years an isolation of the hankruptcy bench and har from the main-

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bankruptcy judges denied these allegations, arguing that defects in the system resulted from their lack of power, not from their abuse of it. They reiterated their view that their powers should be broadened, that an agency should not be created, and that they should continue to have the power to appoint trustees.[105]

The hypothesis that Congress saw an opportunity to increase its patronage powers by seizing appointment powers from the courts receives support from the following exchange between Representative Butler and Attorney General Bell regarding the question of who should appoint bankruptcy judges:

> Mr. Butler. Selection by the President of the United States of bankruptcy judges? Would that disturb you? By the President?
> General Bell. It would not. It would be a little different from what we're doing now, I guess—we're doing it the same way. We have a lot of these appointments.
> As you know, I've been having a lot of problems with U.S. attorneys. That seems to be a big problem in selecting judges. I guess it's more political.
>
> . . . .
>
> . . . You might be charged with giving the party in power more patronage. You have to recognize, if you have a system where the Judicial Council, or even the district judge recommending to the Judicial Council, that they be selected, you have less of a political system. Because some judges are Democrats, some are Republicans.
> If you want to give it all to Democrats, we'd—we, being in power right now, I guess I couldn't object to it.
> Mr. Butler. Patronage is a "burden" of power, I think, in my observation.
> [Laughter.]
> General Bell. It is a burden, I think. It really is that. I wouldn't quarrel with you if you think that's the way to do it.[106]

Bell's initial point was that appointments by the executive and legislative branches are seen as political, because all of the appointments are made by the party in power. Appointments by the judicial branch are not as controversial, because judges belong to different parties. Bell apparently had disliked the political controversies that engulfed the Justice Department because of its role in the appointment of U.S. Attorneys, and, as we shall see, probably feared having to deal with similar controversies if the President were given the power to appoint bankruptcy judges because the Justice Department would have a role in those appointments as well. But he was forced to concede Butler's point which, though sarcastically made, must have been clear to everyone in the room (hence the laughter): the creation of opportunities for patronage benefits the party in power.

Lawyers, as noted, generally supported the creation of the higher status bankruptcy courts and opposed the creation of a bankruptcy agency, but they were divided in some respects. Commercial lawyers and bankruptcy lawyers strongly supported the creation of independent bankruptcy courts.[107] One reason for their support was that in districts where the bankruptcy judge did not use the trustee position as a source of patronage, the bankruptcy lawyers used it as a source of profit:

> Frequently, an attorney that has represented a creditor in past cases will notify him of the bankruptcy of one of the creditor's current debtors. The attorney then obtains a proxy from the creditor to vote the creditor's interest in the case. An attorney may obtain numerous proxies in a particular case in this manner. When the trustee is to be elected, the attorney votes all of his proxies for a col-

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> stream of American jurisprudence and from the judiciary and the legal fraternity generally. Persons practicing in the bankruptcy field tended to confine their activities exclusively to that area, and the Bankruptcy Court, of course, did so from necessity. Therefore, a relatively small group of lawyers controlled the bankruptcy field. Those not within this group tended to regard them with suspicion and distrust.

1975–76 House Hearings, *supra* note 54, at 538 (statement of Harold Marsh, Jr., former chairman of the Bankruptcy Commission), *reprinted* in H.R. REP. NO. 95–595, at 95–96 (1977); *see also id.* at 25 (testimony of H. Kent Presson, Assistant Chief, Bankruptcy Division, Administrative Office of the U.S. Courts); H.R. REP. NO. 95–595, at 95; KENNEDY, *supra* note 45, at 37 (describing the bankruptcy ring); Anne Colamosca, *The Bankruptcy Hustle*, THE NEW REPUBLIC, Feb. 17, 1979, at 15.

[105] *See 1975–76 House Hearings*, *supra* note 54, at 587–88, 592–93 (statement and testimony of George M. Treister, Vice Chairman, National Bankruptcy Conference).

[106] *1977 House Supp. Hearings*, *supra* note 58, at 228–29 (testimony of Attorney General Griffin B. Bell).

[107] *See, e.g.*, *id.*, at 77 (statement of Louis W. Levit, Chairman, Special Committee on the Bankruptcy Act, Commercial Law League of America); *id.* at 238 (National Bankruptcy Conference); *1975–76 House Hearings*, *supra* note 54, at 1538.

league. The colleague thus elected then hires the attorney to serve as counsel to the trustee in the case, assuring a fee for these services. The fee for counsel is usually substantially higher than the fee for the trustee, because it is not limited to a specified percentage under the Bankruptcy Act. In a subsequent case, the colleague and the attorney will switch places.[108]

By electing each other as the trustee and hiring each other as the trustee's counsel, bankruptcy lawyers assured themselves a steady source of business and a steady source of profit.

Another reason that commercial and bankruptcy lawyers supported the enhancement of the status of bankruptcy courts is that lawyers, like bankruptcy judges, care about prestige; just as it is more prestigious to argue in front of federal courts than to argue in front of state courts, so would it be more prestigious to argue in front of high-status bankruptcy courts than to argue in front of low-status bankruptcy courts. Shortly after World War II "bankruptcy lawyers were generally regarded as second-class members of the profession, they were not regarded with the same respect as civil lawyers."[109] Frank Kennedy, the drafter of the CB, ingenuously describes how he and the National Bankruptcy Commission worked to enhance the stature of the bankruptcy bar by trying to effect changes in the law—for example, merging the bankruptcy rules and the federal rules of civil procedure in order to make civil cases in the district court and civil cases in the bankruptcy court as similar as possible.[110] So deeply ingrained was their desire for respect, the bankruptcy lawyers did not see the enhancement of the prestige of the bankruptcy court as a controversial project, or that changing the law to that end might actually make the law worse.

Lawyers as a class were less enthusiastic about the proposed administrative changes but were generally supportive.[111] They, like the federal judges, may have feared that an increase in the power of bankruptcy judges would lead to a general dilution of the status of the federal courts and thus a dilution of the status of lawyers practicing in federal courts. To the members of the American Bar Association this danger must have seemed minimal: they probably believed sensibly that an increase in the status of bankruptcy judges would not dilute the status of federal judges by much. But even so, this loss would hit hardest lawyers who specialized in nonbankruptcy trial work and who thus depended to an unusual degree on the status of the federal courts for their own status. These lawyers did oppose the creation of independent bankruptcy courts.[112]

Lawyers unanimously opposed the creation of a bankruptcy agency, particularly the proposal that it have the role of counseling consumer debtors. The lawyers argued that the agency would "destroy the private consumer bankruptcy bar" and create a "monopoly of lay counselors."[113] The talk of "monopoly" is, of course, just talk: the lay counselors would be government agents, not employees of a single private enterprise. The lawyers objected to the proposal to give the bankruptcy agency the role of counseling consumer debtors because that role threatened a source of business for the lawyers. In addition, the federalization of the trustee system would have reduced the ability of locally influential bankruptcy lawyers to use their connections to obtain the position of trustee or to get themselves hired by the trustee. Lawyers who frequently acted as trustees supported the elevation of the status of bankruptcy courts while opposing the establishment of a bankruptcy agency[114]—in both cases consistently with their interests, narrowly understood.

The creditors generally supported increasing the independence of bankruptcy courts, just because they hoped that higher-status courts would attract better judges and that more powerful bankruptcy courts would be less vulnerable to reversal by

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[108] H.R. REP. NO. 95–595, at 92 (citing *1975–76 House Hearings*, *supra* note 54, at 1252–53 (statement of John Honsberger, Canadian attorney) (discussing corrupt practices in *Canada*)).

[109] KENNEDY, *supra* note 45, at 32.

[110] *See* KENNEDY, *supra* note 45, at 33; *see also id.* at 55 ("[Because of the 1978 Act,] I think, generally, there has been an elevation or improvement of the status of the bankruptcy court and the status of bankruptcy law and bankruptcy administration. . . . That's been my life-long objective, and I think it has been achieved in an important measure.").

[111] The American Bar Association favored a longer transition period and more studies. *See 1977 House Supp. Hearings*, *supra* note 58, at 2 (statement of L. Stanley Chauvin, Jr., Chairman, Task Force on Revision of Bankruptcy Laws, American Bar Association).

[112] *See id.* at 8–10 (statement of Judge Simon H. Rifkind, American College of Trial Lawyers).

[113] *See 1975–76 House Hearings*, *supra* note 54, at 1269, 1270 (testimony of George Ritner, California attorney).

[114] *See, e.g.*, *1977 Senate Hearings*, *supra* note 72, at 495 (testimony of Irving Sulmeyer, Trustee).

higher courts and attendant delays.[115] They opposed the creation of the bankruptcy agency, at least partly because they feared that such an agency would encourage consumers to enter bankruptcy.[116]

The Department of Justice opposed the creation of independent bankruptcy judges and a bankruptcy agency. Attorney General Bell argued that bankruptcy judges should remain adjuncts of the district court, and that, although an official trustee was a good idea, he or she should be placed in the judicial branch.[117] Bell opposed a proposal that the trustees be placed in the Department of Justice rather than in a separate bankruptcy agency, arguing that if the trustees were in the Justice Department, this would create conflict of interest problems, because in many cases the Justice Department would then both represent a creditor (the United States) and participate in the administration of the debtor's estate.[118] Bell also argued that the existing bankruptcy system worked well, and that as long as bankruptcy judges were given sufficient resources, it was not necessary to confer more status on them. Both of Bell's arguments were reasonable, and possibly candid,[119] but other statements he made suggest that the Justice Department, which already managed the President's appointment of federal judges, did not want the additional burden of managing the President's appointment of bankruptcy judges.[120] This was the tenor of the passage quoted above, in which Bell lamented his involvement in political controversies over the appointment of U.S. Attorneys.[121] If this conjecture is correct, he would probably not have wanted the additional burden of managing the trustee system, either. The Justice Department opposed the proposed changes most likely because it would have had to bear the administrative and political costs arising from its role in appointments while gaining no benefits or benefits of uncertain value.

The House Hearings led to a bill that greatly expanded the patronage powers of the executive and legislative branches of the federal government. House Bill 8200 endorsed the idea of the stronger bankruptcy courts, indeed in many respects going beyond the provisions of the JB and the CB. Most significant, House Bill 8200 would have created Article III bankruptcy judges, with life tenure. The House Report argued that it was necessary as a matter of policy to increase the power and status of bankruptcy judges, but this could not be done under Article III of the Constitution unless the judges were given life tenure. This argument was plausible but not decisive, given the state of constitutional theory at the time.[122] The House Report rejected proposals to leave bankruptcy judges as adjuncts of the district court, and it rejected proposals to turn them into Article I judges. In addition, House Bill 8200 gave the bankruptcy judges broad jurisdictional and remedial powers and provided that appeal from a bankruptcy order would be to the circuit court.[123] This last provision was particularly unattractive to the federal judges, because it seemed to put the bankruptcy courts on par with the district courts. House Bill 8200 also followed the Commission's recommendation and created a federal bankruptcy agency, but put

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[115] *See 1977 House Supp. Hearings, supra* note 58, at 194–96 (statement of John W. Ingraham, Vice President, Citibank Corp., and member, Robert Morris Associates Task Force on Bankruptcy); *id.* at 208 (testimony of George Wade, attorney, Robert Morris Associates Task Force on Bankruptcy); *id.* at 237 (testimony of Attorney General Bell) ("I have been a bank lawyer off and on all my life, and I'll guarantee you that the bank would have more confidence with the district judge handling the bankruptcy cases than they would under the present system."); *see also* 1977 Senate Hearings, supra note 72, at 862 (statement of John Creedon, Executive Vice President, Metropolitan Life Insurance Co.).

[116] *See, e.g., 1975–76 House Hearings, supra* note 54, at 1028–29 (testimony of Walter W. Vaughan, Vice President, American Security Bank, and Chairman, American Bankers Association and Consumer Bankers Association Task Force on Bankruptcy); *id.* at 1044–45 (statement of Walter Ray Phillips, Household Finance Corporation, and Associate Dean & Law Professor, University of Georgia); *id.* at 1361 (statement of Alvin O. Wiese, Jr., Chairman, Subcommittee on Bankruptcy, National Consumer Finance Association).

[117] *See 1977 House Supp. Hearings, supra* note 58, at 215–19 (statement of Attorney General Bell).

[118] *See id.* at 218–19.

[119] It appears that the trustee system has not raised problems relating to conflict of interest, so Bell's argument may not have been a frank one, though we have the advantage of hindsight. *Cf.* Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99–554, 100 Stat. 3088 (codified as amended in scattered sections of 11 & 28 U.S.C. (1994)); H.R. REP. No. 99–764, at 17–20 (1986); GENERAL GOVT. DIV., U.S. GEN. ACCOUNTING OFFICE, PUB. NO. GAO/GGD–92–133, BANKRUPTCY ADMINISTRATION: JUSTIFICATION LACKING FOR TWO PARALLEL PROGRAMS, at 15–16 (1992).

[120] *See 1977 Senate Hearings, supra* note 72, at 553 (agreeing that presidential appointment of bankruptcy judges would be a "substantial burden" for the Justice Department).

[121] *See supra* text accompanying note 106.

[122] *See* 1977 HOUSE SUPP. REPORT, *supra* note 57; H.R. Rep. No. 95–595, at 21–39 (1977).

[123] *See* H.R. REP. NO. 95–595, at 21–52.

the agency in the Department of Justice. The administrator would be an appointment of the Attorney General.[124]

Although Senate Bill 2266 gave bankruptcy judges new powers, duties, and privileges (including the right to appoint their own clerks), it did not go so far as the House bill. Senate Bill 2266 did not turn bankruptcy judges into Article III judges, but it did increase their terms from six to twelve years. The power to appoint bankruptcy judges was transferred from district courts to courts of appeal. Administrative functions remained in the judicial branch. No federal bankruptcy agency was to be created.[125] The overall effect was to raise the independence and status of the bankruptcy judges slightly, but not by nearly as much as under House Bill 8200, and to prevent the shift of patronage power from the judiciary to the legislative and executive branches and from the local level to the national level.

The hypothesis that the House's bill[126] was motivated by concerns about patronage should be examined in greater detail.[127] It is, of course, possible that the House believed that increasing the prestige of bankruptcy judges served the public interest, or, more likely, federal judges did not have as much influence on House members as did all the interest groups—creditors, lawyers, bankruptcy judges—that supported the enhancement of the bankruptcy court's prestige. The patronage hypothesis, however, receives support from a recent article, which provides evidence that expansion of the federal judiciary is likely to occur only when the Presidency, the House, and the Senate are controlled by a single political party at the time that the authorizing legislation is passed, and the Presidency and the Senate are controlled by the same party when the nominations and confirmations occur.[128] The authors argue that expansion of the federal judiciary occurs during political alignment because expansion offers the controlling party an opportunity to appoint judges who share its political views and to dilute the influence of the sitting judges who do not.[129] Although this argument is a plausible explanation for the subject of the study—the appointment of Supreme Court justices and federal appellate judges—it is unlikely that Congress cares much about the political views of bankruptcy judges. An alternative hypothesis is that when political alignment exists, Congress creates new judicial positions in part because these new positions can be used for patronage. When House Bill 8200 reached the floor, the Democrats had captured the Presidency as well as the House and the Senate, so the conditions were ripe for judicial expansion. Indeed, in the same year that the 1978 Act was passed Congress also passed the Omnibus Judgeship Act of 1978, which created 35 federal appellate positions and 117 district court positions, considerably more than Congress had ever created before, and the first new positions since the last political alignment in the

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[124] *See id.* at 99–115.

[125] *See* S. REP. NO. 95–989, at 144–59 (1978).

[126] It should be pointed out that the House was not itself unanimous on the status of bankruptcy courts. When H.R. 8200 reached the floor of the House, two representatives proposed an amendment demoting the bankruptcy judge from Article III judge back to adjunct to the district court and eliminating the bankruptcy agency. The amendment passed by a vote of 183 to 158. *See Bankruptcy Revision Bill*, 33 CONG. Q. ALMANAC 571, 571–72 (1977). A few months later, after various parliamentary maneuvers, further hearings, *see 1977 House Supp. Hearings, supra* note 58, and an additional report, *see* 1978 HOUSE REPORT, *supra* note 59, the amendment was defeated by a vote of 146 to 262. Republicans voted 67–73; Democrats voted 79–189. *See Congress Approves New Bankruptcy System, supra* note 41, at 179, 8–H. The lack of unanimity among the Democrats, and especially the tendency of Southern Democrats to side with the Republicans (43 voted against, 40 for), suggest that ideology may have played some role. According to Klee, the original amendment was caused by Justice Burger's lobbying. *See* Klee Interview, *supra* note 82. On this point, *see infra* text accompanying notes 137–141.

[127] Klee, Levin, and Feidler disagree with the patronage theory. Although Klee believes that federal judges and bankruptcy judges exercised patronage prior to the 1978 Act, *see* Kenneth N. Klee, *The New Bankruptcy Act of 1978*, 64 A.B.A. J. 1865, 1866 (1978), he thinks that the transfer of power to the executive and legislative branches of the federal government was motivated by the desire to break up the old patronage system and not by the desire to create a new one. *See* Klee Interview, *supra* note 82, *see also* Feidler Interview, *supra* note 80; Telephone Interview with Richard Levin, Former Associate Counsel to the House Judiciary Committee (Apr. 10, 1997) [hereinafter Levin Interview].

[128] See John. M. De Eiguenedo & Emerson H Filler, *Congressional Control of the Courts: A Theoretical and Empirical Analysis of Expansion of the Federal Judiciary*, 39 J.L. & ECON. 435 (1996). The article shows that for Supreme Court justices and federal appellate judges, political alignment is a significant factor in the timing of expansions, and that both political alignment and caseload pressures are significant factors in the size of the expansions. Other variables—increasing caseloads, requests from within the judiciary, budgetary growth—are not correlated with the timing of judicial expansion at a statistically significant level.

[129] *See id.*

late 1960s.[130] One commentator called the Omnibus Judgeship Act a transfer to the President of "the largest block of judicial patronage in the nation's history." [131]

One might object that Congress did not so much create new bankruptcy court positions as improve old ones; but because existing bankruptcy judges had no right to reappointment after their terms expired, Congress would have the opportunity to exercise its new patronage power. The crucial points are that Congress shifted the appointment power to the executive and legislative branches, and it increased the desirability of the positions, making them more valuable as currency for paying off political debts. If constitutional considerations required Article III status for bankruptcy judges, as further hearings suggested,[132] then so be it. Recall that the Commission members other than the judges sought to create Article III positions.[133]

A similar argument can be made about the bankruptcy agency. The agency would require appointments, and these appointments could be used for patronage purposes. Detailed reasons for putting the bankruptcy agency in the Department of Justice are not given in the House Report—there was only a vague reference to the similar functions of trustees and U.S. Attorneys.[134] One possibility is that this proposal retains most of the patronage opportunities created by the Commission proposal, but the agency, buried in the Department of Justice rather than standing on its own, would not be quite as obviously an expansion of the executive branch.[135] In fact, the drafters of the compromise legislation providing for the pilot program chose districts in states represented by influential senators on the Judiciary Committee precisely for the purpose of giving them a patronage interest in the new appointments, and thus a motive for supporting an expansion of the pilot program into a permanent program at a later date.[136] We will see that the U.S. Trustee system would be used for patronage purposes almost immediately after its creation.

But if these arguments were true, one would expect the Senate to have supported these proposals. After all, under the House bill the Senate retained advice and consent powers over the appointment of bankruptcy judges, and one would expect the Senate's patronage privileges with respect to federal judges would have extended to bankruptcy judges. One possible source of the Senate's resistance is that senators believed that they would have to share some of this patronage power with House members, and the value of patronage appointments to the federal bench—a power enjoyed by senators, not by representatives—would have diminished as a result of the dilution of the federal judiciary.[137] Another reason for the Senate's objections to House Bill 8200 may have been that the Senate feared a transfer of power from the states, from which senators draw their power, to the President. This is consistent with the view that the Senate tends to support the interests of smaller states, which have disproportionate power in the Senate, over the larger states, which have more power in the House and the Presidency. A third and related reason is that many senators were ideologically committed to states' rights and populism, both of which opposed further centralization of authority in the federal government. A fourth reason is that most federal judges have powerful connections in the Senate, but not in the House: these connections are indeed the source of their appointments. An old political debt may not be fully discharged by an appointment to the federal judiciary—that is the problem with a barter economy. A sense of obligation may thus linger. Justice Burger had powerful connections in the Senate—in particular,

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[130] *See id.* at 448 49 tbl. B (describing statistics for appellate courts). Statistics for district courts can be found in ANALYTICAL SERVS. OFFICE & STATISTICS DIV. ADMINISTRATIVE OFFICE OF THE U.S. COURTS, HISTORY OF FEDERAL JUDGESHIPS, 28–29 tbl B. (undated).

It is true that new bankruptcy positions were created in 1984, when government had become divided; so were appellate court positions. But this is just one counterexample: the authors claim statistically significant, not perfect, correlation.

[131] *See* Alan Berlow, *Carter Gets Patronage Plum of 152 Judges*, 36 CONG. Q. WKLY. REP., at 2961, 2961 (1978).

[132] *See 1977 House Supp. Hearings*, *supra* note 58.

[133] A possible objection to the patronage theory is the transition provisions of the bills, which delayed appointment for several years. If Congress was eager to increase its patronage power, why did it delay its ability to exercise that power until a time at which the old political alignment might no longer exist? The answer is probably that it would have been impractical to fire all the bankruptcy judges and replace them immediately.

[134] *See* H.R. REP. NO. 95–595, at 100, 109–11 (1977).

[135] *See infra* text accompanying notes 149–52.

[136] *See* Levin Interview, *supra* note 127.

[137] Federal appellate and district judges are generally chosen by senators from states in the relevant circuit. *See* CONGRESSIONAL QUARTERLY, GUIDE TO CONGRESS 247–48 (4th ed. 1991). Historically, the President has traded his patronage power for legislative support. *See id.* at 248–66, 549–51; RONALD N. JOHNSON & GARY D. LIBECAP, THE FEDERAL CIVIL SERVICE SYSTEM AND THE PROBLEM OF BUREAUCRACY 16 (1994).

Strom Thurmond—but did not have such connections in the House.[138] Moreover, the urban interest groups that had so much influence in the House—creditors and lawyers, especially—had less influence in the Senate. So although the Senate supported some increase in the status of bankruptcy judges, it had many reasons for objecting to an increase large enough to injure their federal judiciary franchise; and the Senate opposed the creation of a bankruptcy agency, because this proposal would have transferred a great deal of local power to the federal government.

But given that expansion of patronage served the interests of Democrats in both chambers, it is no surprise that a compromise was hammered out. The bankruptcy judges would acquire significant new powers and independence, but they would become Article I judges rather than Article III judges. They would become presidential appointments, but their terms were limited to fourteen years, and appeal from their orders would be to district courts. Constitutional concerns[139] were met with assurances from the Chief Justice that the Supreme Court would uphold the new bankruptcy positions.[140] The bankruptcy agency would be put on a hold, but a pilot program would be initiated. The Democratic Party as a whole would benefit from the elevation of the status of bankruptcy judges, and because the party controlled the Senate, the Senate Democrats could be expected to consent as long as suitably compensated for any political disadvantage.

But one problem remained. The compromise may have satisfied the Senate Democrats' fear that they would lose patronage power vis-a-vis the House Democrats. It did not, however, address the federal judges' own desire not to lose any status at all. Hence, the dramatic intervention of Chief Justice Burger. Burger, who had earlier opposed the elevation of bankruptcy judges in a letter to Senator DeConcini[141] and through the Administrative Office of the United States Courts, telephoned DeConcini and other senators, after the House passed the compromise bill, and complained about presidential appointment of bankruptcy judges, their retirement benefits, and their status as adjuncts to the circuit courts.[142] "Burger 'not only lobbied, but pressured and attempted to be intimidating,' DeConcini said. He said the Chief Justice was 'very, very irate and rude.'"[143] Nevertheless, the second Senate amendment threw some crumbs to Burger in the form of remarkably petty reductions in the independence and status of the bankruptcy judges.[144] First, the Senate made it more difficult for bankruptcy judges to acquire clerks, adding a requirement that acquisition be "based on need" rather than based on right.[145] Second, the Senate added to the appointment provision the requirement that the "President shall give due consideration to the recommended nominees of the Judicial Council of the Circuit within which an appointment is to be made."[146] Third, the Senate eliminated the retirement plan of future bankruptcy judges and reduced the retirement benefits enjoyed by incumbents. Fourth, the Senate gave the chief judge of each circuit the power to evaluate the qualifications of incumbent bankruptcy judges who were to continue in the office during the transition. Finally, there is even an ambiguous provision that led Congressman Edwards to raise, but then dismiss, the possibility that

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[138] *See* Levin Interview, *supra* note 127. Participants in the drafting emphasize the importance of the ideological commitments of senators who held crucial positions (Wallop, Eastland), *see* Feidler Interview, *supra* note 80; Klee Interview, *supra* note 82; but these explanations have limited explanatory value. If these senators opposed federal power to such an extent that they resisted the creation of Article III bankruptcy judges, why did they at the same time permit the creation of a huge number of traditional Article III judgeships?

[139] *See 1977 House Supp. Hearings*, *supra* note 58; 1977 HOUSE SUPP. REPORT, *supra* note 57.

[140] Or so it was believed by many representatives, who would later blame Burger for violating a deal when the Supreme Court struck down the bankruptcy positions in 1982. *See* Klee Interview, *supra* note 82. It is possible that the representatives read what they desired into ambiguous statements. *See* Feidler Interview, *supra* note 80.

[141] *See 1977 Senate Hearings*, *supra* note 72, at 878–79 (letter from Chief Justice Warren Burger to Senator DeConcini (Nov. 7, 1977)).

[142] *See* Linda Greenhouse, *Lobbying By Burger Provokes Criticism*, N.Y. TIMES, Nov. 19, 1978, at 39; *Congress Approves New Bankruptcy System*, *supra* note 41, at 180.

[143] *Congress Approves New Bankruptcy System*, *supra* note 41, at 180.

[144] That these concessions were directly in response to Burger's concerns and not motivated by something else is likely, as there is no evidence of any other intervening events. Senator Thurmond "said that the final version approved by the Senate incorporated a number of changes urged by Burger." Mike Shahan, N.Y. TIMES NEWSWIRE, Oct. 7, 1978, at 32; *see also* Robert Feidler & Harry Dixon, *Reflections on the Legislative History of the Bankruptcy Reform Act of 1978*, *in* ANNUAL SURVEY OF BANKRUPTCY LAW 43, 51 (William L. Norton, Jr. ed. 1979). Burger, not satisfied with these concessions, unsuccessfully lobbied President Carter to veto the bill. *See Malcolm Wallop, Footnotes to the Bankruptcy Reform Act of 1978*, *in* ANNUAL SURVEY OF BANKRUPTCY LAW 53, 59 (William I. Norton, Jr. ed., 1979).

[145] *See* 124 CONG. REC. 34,144 (1978) (speech of Hon. Don Edwards) (internal quotation marks omitted).

[146] *Id* (internal quotation marks omitted).

the Senate sought to prevent incumbent bankruptcy judges from referring to themselves as "judges," rather than referees.[147]

Why did DeConcini make these concessions to Burger? There are two possible explanations. First, the vehemence of the federal judges' protest may have led DeConcini to reconsider his judgment that under the compromise bill the Senate would not lose too much patronage power. If federal judges were upset about the bill, that must mean that they expected to lose a great deal of status. If that was so and the position of federal judge would therefore become less attractive, the Senate had lost more patronage power than it had first thought. Second, DeConcini may have worried that the Supreme Court would undo the legislative deal, either by interpreting the statute in a strict way or even by striking down the already constitutionally suspect provisions dealing with bankruptcy judges. The House, in going along with the Senate's unilateral amendment, may have shared this concern. As mentioned earlier, the legislative managers understood the constitutional complications raised by the proposed Article I status of the bankruptcy judges and doubtless feared that an offended Supreme Court could seize upon these complications and undo ten years of legislative work.

Before ending this story, we need to tie two loose ends. First, one might wonder why the Republicans went along with the Democrats' efforts to create patronage positions that only the Democrats would fill. The answer to this question is probably that resistance was futile given the Democrats' large majorities in each house; that little political gain could be achieved from resistance, because the subject was complex and the public uninterested; and that the Republicans may not have objected to the increase in federal patronage opportunities that would benefit them if and when they returned to political power. Note that when the House Democrats split over the question of elevating the status of bankruptcy judges and creating a bankruptcy agency, the Republicans sided with the dissenters—an indication that they opposed the increase in patronage that would benefit Democrats.[148]

Second, we noted earlier that the more sophisticated public choice models give some role to the electorate. Politicians do not make transfers to special interests when voters observe these transfers, disapprove of them, and respond to them by voting against the politicians when they run for reelection. One hypothesis is that politicians will choose an inefficient form of a transfer in order to conceal it from the voters.[149] This hypothesis sheds light on some features of the legislative history of the Code. It seems likely that Congress modified the role of the bankruptcy judge in such a way that increased status, rather than simply increasing salary, because voters would more likely observe and object to the increase in salary. Thus did the 1977 House Report quote approvingly from a Justice Department report: "We will never pay the incomes to judges that they could earn in other pursuits and we must not create conditions that require us to settle for second best in the federal courts."[150] The reason that judges cannot be paid their market value may be that voters do not want to spend that much on judges, or (more likely) judges' salaries are linked to Congressional salaries and voters do not want to spend too much on members of Congress.[151] In either case, payment in status is a disguised transfer, designed to circumvent the political restrictions on payment in money. In addition, we saw that the House decided to put the bankruptcy agency within the Justice Department rather than creating a new federal agency along the lines proposed by the Commission. In doing so, the House lost the opportunity to create a valuable presidential appointment; but it also reduced the likelihood of accusations of patronage. Voters and their watchdogs are more likely to object to the addition of a new agency to the federal bureaucracy than to some tinkering with the internal structure of an existing agency.[152]

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[147] *See id.*

[148] *See Congress Approves New Bankruptcy System*, *supra* note 41, at 179, 8–H.

[149] *See, e.g.*, Stephen Coate & Stephen Morris, *On the Form of Transfers to Special Interests*, 103 J. POL. ECON. 1210 (1995).

[150] H.R. REP. NO. 95–595, at 22 (1977) quoting COMMITTEE ON REVISION OF THE FED. JUDICIARY, U.S. DEPT. OF JUSTICE, THE NEEDS OF THE FEDERAL COURTS 7 (1977)).

[151] In 1975 Congress linked salaries of members of Congress to those of other federal workers in an effort to disguise salary increases benefiting themselves. *See* R. DOUGLAS ARNOLD, THE LOGIC OF CONGRESSIONAL ACTION 104 (1990).

[152] There is a third question. How could it be the case both that bankruptcy judges expected to gain from the 1978 Act through reappointment and enhances status, and that Congress expected to gain through increased patronage powers? If the judges kept their jobs, Congress would have been unable to have other people appointed. The answer is probably that the bankruptcy judges predicted (accurately) that they would be able to keep their jobs for a while, given the dislocation of transition, and that Congress saw the change as a relatively long-term change. In 1977 and 1978 future Republican power could not have been foreseen.

Although our story ends in 1978, the reader may be interested in subsequent events. In 1982 the Supreme Court struck down the provisions in the 1978 Act relating to the position of bankruptcy judges.[153] The Court held that the Act violated the Constitution by giving Article III powers to judges who do not have lifetime tenure and independent salaries. Justice Burger joined the dissent, which argued that the bankruptcy courts could be considered limited Article I courts. House members felt that Burger had broken a promise to deliver Supreme Court approval of the 1978 Act.[154] Brennan, Marshall, and Blackmun, joined by Powell, formed the plurality. The outcome is probably attributable to their commitment to the independence of the federal judiciary, and not to the fact that much of the patronage power in the federal government had shifted to the Republicans in 1981. Rehnquist and O'Connor concurred on narrower grounds. Congress responded in 1984 by placing the bankruptcy judges more solidly under the authority of the district courts.[155] The way in which constitutional constraints interfered with attempts by the relevant political agents to strike a deal, one that gave bankruptcy judges more power but not too much more power, is worth some thought. They forced the participants either to keep the bankruptcy judges completely subordinate to the district courts or to make them Article III judges, as the House sought, and denied them an important route of compromise.

In 1986, the U.S. Trustee program was made permanent and expanded to cover every state, except Alabama and North Carolina.[156] But in the meantime the patronage hypothesis—at least in outcome if not necessarily in intent—was confirmed. According to the first director of the Executive Office for U.S. Trustees, in the early 1980s "the Department of Justice expressly said the [U.S. Trustee] program would get more support if politicians were invited to make U.S. Trustee appointments. They actually solicited various senators for their views as to who the U.S. Trustee should be."[157] In doing so, the Justice Department merely followed the plan of the drafters.[158] Similar, albeit not quite as credible, claims were made about the trustees appointed by the U.S. Trustees. One bankruptcy judge said:

> When the pilot project started, I thought, "Maybe this is a good idea. Perhaps it will take some of the politics and favoritism out of the system," . . . I quickly realized that it didn't. It just switched whose ox was being gored by whom. It was the U.S. Trustees' friends who were now being appointed as panel trustees.[159]

Aside from patronage concerns, there is a general view that the U.S. Trustee system has not worked well; this view will be discussed in the conclusion.

VI. EXEMPTIONS

Federal and state interests divided even more sharply over exemption policy than they did over administrative structure. States had controlled exemption policy since the United States had come into existence. On the eve of the 1978 Act, federal bankruptcy law incorporated state exemptions, and although federal law supplemented state exemptions with a handful of federal exemptions (for foreign service workers, fishermen, seamen, longshoremen, railroad workers, and veterans[160]), the federal exemptions did not play a significant role in bankruptcy cases. The legislative history of the 1978 Act displays an effort by federal authorities once again to wrest control of exemption policy from the states.

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[153] *See* Northern Pipeline Constr. Co. v. Marathon Pipe Lane Co., 458 U.S. 50 (1982).

[154] *See* Klee Interview, supra note 82. This may explain why Burger insisted in a separate opinion that the plurality did not hold that the bankruptcy courts violated Article III and that the holding should be interpreted more narrowly. *See Northern Pipeline*, 458 U.S. at 92 (Burger, C.J. dissenting) ("I write separately to emphasize that, notwithstanding the plurality opinion, the Court does *not* hold today that Congress' broad grant of jurisdiction to the new bankruptcy courts is generally inconsistent with Art[icle] III of the Constitution.").

[155] *See* Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L., No. 98–353, §§101(a), 104(a), 98 Stat. 333, 333, 336–41 (codified as amended at 28 U.S.C. §§151–58, 1334 (1994)).

[156] *See* Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pul. L. No. 99–554, 100 Stat. 3088 (codified as amended in scattered sections of 11 & 28 U.S.C. (1994)).

[157] *How the U.S. Trustee Program Got Politicized*, 29 Bankr. Ct. Dec (CRR) A7, A7 (Oct. 22, 1996) (quoting Richard Levine, former Director, Executive Office for U.S. Trustees).

[158] *See supra* text accompanying note 136.

[159] *Why Is the U.S. Trustee Program Such a Lightening Rod*, 29 Bankr. Ct. Dec. (CRR) A1, A8 (Oct. 22, 1996) (quoting anonymous bankruptcy judge).

[160] *See* S. REP. NO. 95–989, at 75 (1978).

To understand the conflict over exemption policy, one must distinguish the issue of federalism and the issue of the proper content of exemption law. The issue of federalism concerns whether the federal government or the states will have control over exemption policy. The issue of content concerns the proper level of generosity of exemption law, including both the monetary value of protected property and the kind of protected property. If politicians can gain political rewards by changing exemption law (in whichever direction), then one should expect a conflict between federal and local authorities over the power to control exemption law. If some interest groups have more power at the federal level while others have more power at the state level, then one should expect the former to prefer federal control of exemption policy and the latter to prefer state control of exemption policy. But whether control of exemption policy lies in the hands of state politicians or in the hands of federal politicians, interest groups will lobby the appropriate government for the exemption rules they prefer.

These observations raise the question whether the politicians involved in bankruptcy reform during the 1960s and 1970s actually believed that having control over exemption law was valuable. At first sight, one might think not. As noted earlier, many of the states' exemptions were archaic, providing protection for participants in an economy that no longer existed. Many states had not amended their exemption laws in dozens of years. If control of exemption law provided a fruitful means of making political payoffs, one might expect the kind of constant tinkering with it that one sees in tax law. The dominant view of commentators writing before the enactment of the Bankruptcy Code was that state legislatures did not care about exemption law.[161]

This view, however, was wrong. Control over exemption policy had proved its value to state politicians in many ways. First, control over exemption law had allowed state authorities to respond to the demands of newly powerful classes of overburdened debtors during times of economic depression. Again and again during the nineteenth and twentieth centuries, states increased the generosity of exemption laws when an economic downturn caused default by debtors in large numbers.[162] This legislation interfered with efforts by creditors to seize property to satisfy unpaid debts. The enactment of such laws must have been a straightforward and effective way for politicians to earn the gratitude of a large number of highly interested voters, the overburdened debtors, without alienating continuing debtors, who were probably sympathetic to the plight of overburdened debtors, and without risking much retaliation from the creditors, whose political power ebbed during economic downturns. Second, a glance at the current state exemption laws reveals the fingerprints of traditional interest groups. The exemption laws of virtually every state single out for favorable treatment groups of well-known political influence, such as insurance companies, farmers, teachers, veterans, and charitable organizations.[163] Third, at least one state (Texas) and possibly others that sought to expand their population in the nineteenth century used exemption laws to encourage immigration from other states. By prohibiting creditors from collecting from the assets of residents, a state's generous exemption law encourages overburdened debtors to immigrate—a practice that continues to this day.[164] Although it is true that many of the exemption laws on the books go back more than a hundred years, most states did modify their exemption laws from time to time, and they continue to do so even today.[165]

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[161] *See, e.g.* Countryman, *supra* note 30.

[162] *See* PETER J. COLEMAN, DEBTORS AND CREDITORS IN AMERICA (1974); CHARLES WARREN, BANKRUPTCY IN UNITED STATES HISTORY (1935); Paul Goodman, *The Emergence of the Homestead Exemption in the United States: Accommodation and Resistance to the Market Revolution, 1840–1880,* 80 J. AM. HIST. 470 (1993).

[163] Massachusetts, for example, singles out benefits from various insurance policies, see, *e.g.*, MASS. GEN. LAWS ch. 175, § 110A (Supp. 1997) (accident and sickness insurance), farming products, *see* MASS. GEN. LAWS ch. 235, § 34 (1975), pensions of public employees, see MASS. GEN. LAWS ch. 32, § 19 (1993), veterans' benefits, *see* MASS. GEN. LAWS ch. 115, § 5 (1981), and fraternal benefit society benefits, *see* MASS. GEN. LAWS ch. 176, § 22 (1958).

[164] *Cf. 1975–76 House Hearings, supra* note 54, at 1369 (statement of Alvin O. Wiese, Jr., Chairman, Subcommittee on Bankruptcy, National Consumer Finance Association).

[165] For example, Connecticut created a new $75,000 homestead exemption in 1992, *see* 1993 Conn. Acts. 93–301, § 2 (Reg. Sess.) (codified as amended at CONN. GEN. STAT. ANN. § 52–352b(t) & note 10 (West Supp. 1997)); California raised its homestead exemptions in 1990, 1990 Cal. Stat. ch. 155, § 1 (codified as amended at CAL. CIV. PROC. CODE § 704, 730 & note (West Supp. 1997)), and created a $5000 exemption for jewelry, heirlooms, and art in 1995, 1995 Cal. Stat. ch. 196, § 2 (codified as amended at CAL. CIV. PROC. CODE § 704.040 (West Supp. 1997)); Arizona raised its homestead exemption in 1989, *see* 1989 Ariz. Sess. Laws. ch 90, § 1 (codified as amended at ARIZ. REV. STAT. ANN. § 33–1101 (West 1990)); and Washington modified its motor vehicle

If control over exemption policy was valuable to state politicians, then it must have appeared valuable to federal politicians as well. Control over exemption policy would have given federal authorities the power to provide relief to debtors in times of economic distress. More immediately, Congress would have the power to create exemptions that benefited insurance companies, banks, farmers, and other groups that could provide the greatest political support. To the extent that local control of exemption law created spillovers, control over exemption policy would allow the federal government to eliminate those spillovers and gain the support of those whom they injured. These considerations no doubt motivated the unsuccessful efforts of Congress to seize control of exemption policy in the nineteenth century and its successful efforts to create exemptions for particular categories of workers. And the same motivations would cause some members of Congress to use the widespread belief in the need for bankruptcy reform in the 1960s and 1970s as an excuse for the federal government to seize control of exemption policy from the states yet again.

The normative case for federal control of exemption policy, however, was weak. The academic critics in the 1950s and 1960s argued that Congress should enact a system of uniform federal exemptions on the grounds that the state exemptions were too often archaic, too variable, and too generous or too mean;[166] but they never explained why control of exemption policy should lie with the federal government rather than with the states.[167] The variability of exemption law suggested, if anything, that tastes about credit risk and protection against default differed greatly from locality to locality and that therefore uniformity imposed at the national level would have served no purpose.

The strongest case for uniform federal exemptions arises from the problem of spillovers. When states enact inconsistent laws, there sometimes results a "race to the bottom," in which all states become worse off as a result of their competition for resources. A common example is that of pollution: in the absence of federal pollution laws, states would enact suboptimal pollution laws because the cost of pollution is partly born by downwind or downstream states, while the benefits of weak pollution laws, in the form of jobs and industry, accrue to the state that enacts the law. But if all states follow this logic, the aggregate costs will exceed the aggregate benefits. Uniform federal environmental laws would solve this prisoner's dilemma.

One analogy with respect to exemption laws concerns their effect on migration. As noted above, Texas originally created generous exemption laws to encourage migration from other states. Texas may correctly have calculated that the benefits of an increased population would exceed the higher cost of credit incurred by its citizens; but if all states had enacted generous exemption laws for this purpose, the migration gains would have disappeared while the cost of credit would have remained high everywhere. By preventing states from competing for migrants through exemptions, a uniform federal exemption law would prevent the race to the bottom. The problem with this argument, however, is that whatever the truth about Texas' motives in the nineteenth century, it is doubtful that modern states use exemption law to encourage migration, because people probably do not take exemption laws into account when deciding whether to migrate.[168]

Another possible source of spillovers might be efforts by states to externalize the cost of default. If one state's exemption regime is more generous than those of other states, perhaps national creditors would spread the increased cost of collection in the high-exemption state among debtors in all the other states. All debtors would pay the same higher interest rate, but debtors in the high-exemption state would, in effect, pay less in interest charges for their right to keep more assets in case of default. But if the other states responded by increasing their exemptions, this benefit would be lost, while debtors in all states would pay the high interest rates—in effect, paying for more protection in case of default than they want. The problem with this argument, however, is that national creditors (to say nothing of local credi-

exemption in 1991, 1991 Wash Laws ch. 11, § 5 (codified as amended at WASH. REV. CODE § 6.15.010 (1996)).

166 *See, e.g.*, Countryman, *supra* note 30; Comment, *supra* note 30.

167 *See* Kennedy, *supra* note 30, at 445–46, 451–53 (making this criticism).

168 *Cf.* Schill, *supra* note 11, at 1295 & n.173. One study finds a statistically significant correlation between the level of Chapter 7 filings in a state and the amount of immigration into that state, *see* Margaret F. Brinig & F.H. Buckley, *The Market for Deadbeats*, 25 J. LEGAL STUD. 201 (1996), but because most studies find no relation between the level of Chapter 7 filings in a state and the generosity of its exemption laws, *see infra* note 254, the results of the study provide no reason for believing that generous exemption laws attract migrants.

tors) can adjust interest rates by state, charging the debtors in high-exemption states higher interest rates than they charge debtors in low-exemption states.[169]

A third possible source of spillovers might be efforts by states to externalize the cost of poverty. Citizens in each state might believe that exemption laws should cushion people against bad luck or improvidence but fear that generous exemption laws would attract poor people from other states. Uniform exemptions would resolve this fear. The problem, again, is that no evidence suggests that generous exemption laws attract migrants in large numbers.

If spillovers caused significant losses, one would expect efforts by the states to produce a uniform law, because the reciprocity of the supposed harm means that uniformity would have produced mutual gains.[170] Yet the uniform exemptions law recommended in 1976 by the National Conference of Commissioners on Uniform State Laws was enacted by just one state![171]

Despite the shaky normative foundations for nationalizing exemption law, that idea made it onto the agenda of bankruptcy reform in the 1970s. The Commission endorsed the idea of uniform federal exemptions without justifying its position. It simply referred to the great diversity of state exemption laws.[172] The particular exemptions contained in the CB—for example, $5,000 homestead plus $500 per dependent and $1,000 for general personal property—were also not explained. In addition, the CB provided that the exemptions would be nonwaivable and gave the debtor the right to avoid judicial liens in exempt property and nonpurchase money security interests in household goods. The JB provided for a set of *minimum* federal exemptions—including $6,000 plus $600 per dependent for the homestead and $3,000 for general personal property—and allowed the states to choose higher exemptions so long as they did not in the aggregate exceed $25,000.[173]

It may seem facile to argue that the Commission favored uniform federal exemptions because they would transfer power over exemption policy from the states to the federal government. But recall that four of the nine members were members of Congress—including Burdick and Edwards, the legislative managers for the Senate and House—and three were presidential appointees.[174] The two federal judges on the Commission also probably had no objections—political or philosophical—to federal exemption law.[175] The entire membership of the Commission comprised people whose position, influence, and interest were connected with the federal government; seven of the nine members either would directly benefit from a transfer of the power over exemption law from the states to the federal government or were appointed to the Commission by someone who would benefit from such a transfer. As agents of the federal government, they sought an expansion of its power. Against this, one might object that the Commission members simply did not realize that state authority over exemptions could be justified on normative grounds. They failed to provide a rationale for federal exemptions because the rationale was, in their minds, obvious. But this theory overlooks the fact that the reporter for the Commission, Frank Kennedy, had written an article defending the old law's incorporation of state exemptions just 13 years before the release of the Commission's report.[176]

Although bankruptcy judges were officials of the federal government, their power was local. Unlike the Commission members, they did not have an interest in transferring power over exemption law from the states to the federal government. Indeed, if they had any interest at all in the subject of exemption law, it was either to simplify it, in order to make their jobs easier, or not to change it, in order to avoid having to learn new law. The JB's endorsement of minimum federal exemptions may have been a compromise between these impulses. It may also have been designed to appeal to Congress, in order to give the bill legitimacy and plausibility. The $25,000 ceiling is hard to explain; perhaps the bankruptcy judges thought that bankruptcy law would seem illegitimate if wealthy people could obtain protection

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[169] Schill considers and rejects a similar spillover argument for state real estate exemption laws and related laws. *See* Schill, *supra* note 11, at 1288–96.

[170] *Cf.* Larry E. Ribstein & Bruce H. Kobayashi, *An Economic Analysis of Uniform States Laws*, 25 J. LEGAL STUD. 131, 137–41 (1996).

[171] *See id.* at 188–89 app. tbl. AI.

[172] *See* H.R. DOC. No. 93–137, at 10, 170–73 (1973)

[173] *See 1975–76 House Hearings, supra* note 54, at 146–47 app.

[174] The only federal agency to testify on this topic, the Federal Trade Commission's Bureau of Consumer Protection, supported uniform minimum federal exemptions. *See 1975–76 House Hearings, supra* note 54, at 758–63 (statement of David H. Williams, Attorney, Bureau of Consumer Protection, Federal Trade Commission).

[175] The Administrative Office of the U.S. Courts supported uniform federal exemptions. *See, e.g., 1975–76 House Hearings, supra* note 54, at 20 (statement of H. Kent Presson, Assistant Chief, Bankruptcy Division, Administrative Office of the U.S. Courts).

[176] *See* Kennedy, *supra* note 30.

from it. At any rate, this idea would have no influence on subsequent events. Because the bankruptcy judges did not share the Commission members' interest in federalizing exemption policy, they preferred to leave some of exemption policy under local control.

Rather than choosing between the CB and the JB, House Bill 8200 established a set of federal exemptions but gave the debtor the right to choose between the federal exemptions and the state exemptions. This approach effectively meant that the federal exemptions provided a floor. These exemptions included $10,000 for the homestead and $5,000 for miscellaneous personal property. In addition, House Bill 8200 followed the CB in making the exemptions nonwaivable and giving the debtor the right to void a judicial lien in exempt property and a nonpurchase money security interest in household goods and related property. Senate Bill 2266 followed the 1898 Act and left exemption policy to the states. Although it added a right to redeem, it did not create rights to void any liens.

Why did the House retreat from uniformity and propose instead a federal floor? There is little evidence bearing on this question, but it is possible to make some conjectures. One conjecture is that state officials made their influence felt behind the scenes. Although state officials' first choice would have been to retain complete control over exemption policy, their influence may have been strong enough only to effect a compromise in which they retained control over the ceiling, the Congress over the floor.

Another conjecture emerges from the conflicting behavior of creditors. One might believe that creditors would, as a group, prefer a federal ceiling to a federal floor and that House Bill 8200 represented a defeat. In fact, the story is more complicated. The American Bankers Association supported minimum federal exemptions,[177] while the National Consumer Finance Association and the National Credit Union Association favored uniform federal exemptions.[178] Insurance companies[179] and the National Association of Credit Management[180] favored state control over exemption policy. To explain this distribution of positions, observe that creditor groups whose members were locally powerful—banks, insurance companies, and local businesses—preferred either complete state control or some state control.[181] Creditor groups whose members were not locally powerful—credit unions, finance companies[182]—preferred more federal control. Because their power was greater at the federal than at the local level, the credit unions and finance companies believed that their influence could ensure that only federal, not local, exemptions would be sufficiently low. Whatever the content of exemption law, creditors likely preferred authority over exemption policy at that level of government over which they had the most influence.[183]

Creditors may also have tried to use the opportunity of exemption reform to gain competitive advantages in the credit market. Banks issued lower risk credit, either secured or unsecured, and apparently, because of fear of bad publicity, usually avoided pursuing debtors too aggressively—for example, by taking household goods as collateral or seizing them from defaulting debtors.[184] Consumer finance companies issued higher risk credit, both secured and unsecured, and did take household

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[177] *See 1975 Senate Hearings*, *supra* note 71, at 128, 136 (statement and testimony of Walter W. Vaughan, Vice President, American Security Bank, and Chairman, American Bankers Association and Consumers Bankers Association Task Forces on Bankruptcy).

[178] *See, e.g.*, *1975–76 House Hearings*, *supra* note 54, at 1368–69 (statement of Alvin O. Wiese, Jr., Chairman, Subcommittee on Bankruptcy, National Consumer Finance Association).

[179] *See id.* at 1584–85 (statement of John J. Creedon, Chairman, Subcommittee on Federal Bankruptcy Legislation, American Life Insurance Association); *id.* at 1645–49 (letter from National Association of Insurance Commissioners to Representative Don Edwards, Chairman, Subcommittee on Civil and Constitutional Rights).

[180] *See id.* at 1674 (statement of Richard Kaufman, National Association of Credit Management). The National Association of Credit Management consists of manufacturers, distributors, financial institutions, and firms in service industries.

[181] According to Klee, it was generally understood that banks had significant influence at the state level and used their influence on governors, who made their influence felt at the federal level through the National Association of Attorneys General. *See* Klee Interview, *supra* note 82. The political power of banks in many states is confirmed by research. *See, e.g.*, SARAH MCCALLY MOREHOUSE, STATE POLITICS, PARTIES AND POLICY 108–12 (1981).

[182] A list of interest groups that have power at the state level contains banks, business, and insurance companies, but not credit unions and finance companies. *See* MOREHOUSE, *supra* note 181, at 108–12 tbl. 3–2.

[183] *Cf.* THOMAS R. DYE, POLITICS IN STATES AND COMMUNITIES 55 (3rd ed. 1977) (finding that oil companies preferred state regulation over offshore oil wells to federal regulation, because they feared having less influence over federal regulators than they already had over state regulators).

[184] *See* Letsou, *supra* note 14, at 632–33.

goods as collateral.[185] If typical bank credit—especially, mortgage loans and loans secured by personal property—and finance company credit were close enough substitutes that an increase in the price of one would increase the demand for the other, then banks may have supported minimum federal exemptions in the hope that the higher effective exemption level that would result in states that had stingier exemptions would reduce the amount of collateral available to consumer finance companies without affecting the amount of collateral available to banks. [186]

This conjecture is supported by evidence of two related conflicts between banks and consumer finance companies. The first conflict occurred over the right of redemption. Creditors generally dislike the right of redemption because it gives debtors the capacity to impose delay and litigation costs on the creditors, and debtors use the threat of delay to obtain some loan forgiveness. A limited right to redemption, however, would have a differential impact on creditors. Consider the right to redeem limited to goods, not real property, and excluding goods subject to purchase money security interests. This limited right to redeem injures the consumer finance companies, which depend heavily on nonpurchase money security interests in household goods; but it does not injure banks, because they depend mostly on real estate mortgages and purchase money security interests. The limited right to redeem thus might force the consumer finance companies to raise interest rates, driving their customers into the arms of the banks, whose interest rates would be unaffected. This may explain why in the legislative history banks supported a right to redemption of collateral except that used for purchase money security interests,[187] while the consumer finance companies' opposed the right of redemption.[188] The banks prevailed.

The second conflict occurred outside of the context of bankruptcy. When the FTC proposed rules restricting wage assignments and security interests in household goods, the consumer finance industry responded by challenging them through political and legal channels, whereas the banks remained mostly passive. An empirical study shows that legal restrictions on wage assignments reduced the amount of credit issued by consumer finance companies while not affecting the amount of credit issued by banks (and improving the position of credit unions).[189] Although this study does not show that legal restrictions on security interests in household goods produced similar results, the logic is similar and so banks may have thought this result likely. The banks' passivity suggests that they saw in the proposed rules a competitive advantage.[190]

Finally, insurance companies had done well at the state level. The exemption of insurance proceeds in many states encouraged debtors who anticipated bankruptcy to sell off nonexempt property and purchase insurance. The insurance industry likely supported state control of exemption policy, because it did not want to risk losing its favorable position.

The national lawyer groups, such as the National Consumer Law Center[191] and the Commercial Law League, supported federal control of exemption law, and their influence on Congress was greater than that of the local bar associations, which generally supported state control. Presumably, each group preferred seeing exemption policy in control of the level of government over which it had the most influence, but since it was Congress that was making the decision, the national groups did better than the local groups.

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[185] *See id.* According to the FTC, although banks sometimes rely on nonpurchase money security interests in household goods, "[f]inance companies are the preeminent users." Trade Regulation Rule, 49 Fed. Reg. 7739, 7762 (Federal Trade Commn. 1984) (credit practices) (commentary on 16 C.F.R. §444).

[186] A study of credit data from 1978 to 1983 found competition between bank automobile loans and finance company personal loans, bank personal loans and finance company personal loana, and bank mortgages and finance company personal loans. *See* Gregory E. Elliehausen & John D. Wolken, *Market Definition and Product Segmentation for Household Credit*, 4 J. FIN. SERVICES RES. 21 (1990).

[187] *See 1975–76 House Hearings, supra* note 54, at 1025, 1039–40 (statement and testimony of Walter W. Vaughan, Vice President, American Security Bank, and Chairman, American Bankers Association and Consumers Bankers Association Task Forces on Bankruptcy).

[188] *See id.* at 1045–46 (statement of Walter Ray Phillips, Household Finance Corporation); *1977 Senate Hearings, supra* note 72, at 651 (statement of Alvin O. Wiese, Jr., Chairman, Subcommittee on Bankruptcy, National Consumer Finance Association).

[189] *See* Daniel J. Villegas, *Regulation of Creditor Practices: An Evaluation of the FTC's Credit Practice Rule*, 42 J. ECON. & BUS. 51, 64, 65 tbl.3 (1990).

[190] *See* Letsou, *supra* note 14, at 634–35.

[191] The NCLC supported minimum federal exemptions. *See 1975–76 House Hearings, supra* note 54, at 937–38 (statement of Ernest L. Sarason, Jr., Staff Attorney, National Consumer Law Center).

We can summarize the argument so far in the following way. Consider the biggest winners and losers from the federal exemption floor. In the stingy states the continuing debtors and creditors as a group would lose, but the lawyers, the overburdened debtors, and possibly certain powerful classes of creditors, such as the banks, would win. The losers had less political power at the national level than the winners did, especially because, as we saw, the creditors were divided by their interests. In the generous states a federal exemption floor would have had no effect.

Now consider the winners and losers from uniform federal exemptions. The story is the same for the stingy states, but in the generous states, now the lawyers, possibly the overburdened debtors, and certain creditors would lose, while the continuing debtors and creditors as a group would gain. In other words, the politically weak would prevail.

Minimum federal exemptions benefited some politically powerful groups without offending any other politically powerful groups, so they were preferred to uniform federal exemptions, which offended the politically powerful groups in the more generous states.

This argument raises the question why the Senate sought to leave exemption policy to the states. If the House would have gained from enacting a minimum exemption law because it would transfer payoffs from the state governments to the federal government, why wouldn't the Senate have gained as well? To answer this question, we must consider in more detail the relationship between local and national authorities.

We have been assuming so far that the federal government would seize political power from state governments whenever it could, but this assumption conflicts with observed behavior. In fact, there are two reasons why the federal government might leave certain areas of the law to the states, even though it has the constitutional power to legislate in these areas itself.[192] First, when local interests have invested resources in understanding existing state legislation, they stand to lose their valuable legislation-specific expertise if Congress enacts superseding law. Recall that bankruptcy lawyers resisted the Chandler Act apparently because of the fear that it would eliminate the relevance of their expertise.[193] To avoid this kind of loss, lawyers will pay off the federal government, either by giving support directly to federal politicians or by using their local influence to cause state politicians to pay off federal politicians.

It is true that bankruptcy lawyers and judges had valuable expertise regarding the nuances of state exemption law—the complexity of which cannot be exaggerated—and would have been reluctant to lose it. Indeed, the bankruptcy judges and many lawyers—and particularly local organizations, like state bar associations—opposed uniform federal exemptions and supported either state control or no more than a federal floor.[194] Still, this story is not very satisfying. Exemption law composed a small portion of the bankruptcy lawyers' and judges' expertise, and with respect to other areas of bankruptcy law, far from opposing reform out of a desire to maintain the relevance of their expertise, they enthusiastically supported it.

The second reason why the federal government leaves legislative power with state governments is that state governments have greater information about local interests than the federal government does and can therefore satisfy them more successfully; either the state governments or these local interests can take enough of the surplus from more efficient state regulation to be able to "pay" the federal government more than the latter would obtain through direct regulation. It is plausible that state politicians had quicker and more accurate access to information about the optimal level of exemption for the interests that benefited from it than did federal politicians. As a result, state officials had a greater ability to tailor exemption policy

[192] Thia is loosely based on Jonathan R. Macey, *Federal Deference to Local Regulators and the Economic Theory of Regulation: Toward a Public Choice Explanation of Federalism*, 76 VA. L. REV. 265 (1990). *See also* Robert P. Inman & Daniel L. Rubinfeld, *The Political Economy of Fedealism*, *in* PERSPECTIVES ON PUBLIC CHOICE: A HANDBOOK 73 (Dennis C. Mueller ed., 1997).

[193] *See supra* note 34.

[194] Local lawyers favored state control over exemptions, or federal minimum exemptions. The latter policy may have seemed attractive because it would allow them to use local influence to ratchet up exemptions without risking a reduction in the level of exemptions. Debtors' lawyers probably preferred high exemptions, because it increases the demand for their services; it is hard to say what creditors' lawyers would want. *See, e.g.*, *1975–76 House Hearings*, *supra* note 54, at 1256 (statement of Robert Ward, California bankruptcy attorney) (supporting state exemptions); *id.* at 1339 (statement of Paul. L Winkler, California bankruptcy attorney) (supporting federal minimum exemptions); *id.* at 1558 (testimony of Louis W. Levit, Commercial Law League) (discussing support for federal uniform exemptions); *id.* at 1658 (statement of L.E. Creel, III, Dallas Bar Association) (supporting minimum federal exemptions).

to the idiosyncracies of their state.[195] In one state, for example, insurance companies are powerful and would pay a lot for exemptions for insurance proceeds; in another state, the farmers have all the power. If state officials could earn more political support from controlling exemption policy than federal officials could, then the parties had an incentive to make a deal in which the federal officials leave exemption control in state hands in return for some kind of "payment." The form of "payment" could, of course, vary. State officials might promise to supply patronage to federal officials or to support them in elections. In addition, interest groups with both local and national power could deter a federal takeover of exemption policy from the states by threatening to withhold support.

These stories suggest two reasons why the Senate and the House came into conflict over the level of government control of exemptions. First, senators owed more of their political power to state political organizations than representatives did. Exemption policy does not interest people at the district level; it does at the state level, since the state, not the district, is the source of state law. Second, the Senate was disproportionately influenced by the less populous, more rural states.[196] The powerful farming lobbies in those states care deeply about a transfer of control over exemption policy from the states, where their influence is strong, to the federal government, where their influence is diluted. Since their influence at the federal level is stronger in the Senate than in the House, however, they can use their national influence to block the transfer.

Another reason for the difference may have been personal or ideological. Senator Wallop was a believer in state's rights and had recently been involved, as a state politician, in the amendment of Wyoming's exemption laws. As chairman of the Judiciary Committee, he had disproportionate control over the legislation, and apparently he cared only about this issue. Many senators had similar views about states' rights, whereas the House was dominated by believers in New Deal liberalism and centralized government.[197] It remains an open question, however, whether members cared enough about these ideological commitments to resist pressures from interest groups.

The compromise bill in Stage 3 provided still another variation on exemption law: a set of uniform federal exemptions, including the power to avoid certain liens, with a state right to opt out. The compromise meant that a state could, by legislative direction, force debtors to use exemptions that are lower than the federal exemptions; or it could force debtors to use exemptions that are higher than the federal exemptions; or it could leave the debtor the choice of using federal or state exemptions. The opt-out idea ingeniously gave the federal government control over exemption policy in all the states for which the interest in exemption policy was low, but not from the states that had a powerful interest in control of exemption policy. As a result, the federal government picked up some power without offending those with the most to lose. Most states did, in fact, opt out, showing again that the states did care about controlling exemption policy. Nevertheless, Congress gained some control over exemption policy.

There is one last question. Why was it never proposed that Congress create *non-uniform* exemptions—that is, exemptions that vary from state to state? After all, Congress had often enacted legislation that affected states differentially—for example, laws relating to building projects. Such a proposal would have allowed Congress to give each state the exemption law that maximized value to local interests and to gain in return the maximum amount of political support. The answer may be that Congress could obtain creditor support for federal exemption law only by promising to make exemption law uniform or at least more uniform than it had been. Creditors disliked the ability of debtors to change residences under the old law in order to escape collection.[198] Another possible answer is that because one of the most powerful justifications for bankruptcy reform was the complexity of the old bankruptcy law, federal differential exemptions would have appeared to be a step backwards. A final answer, consistent with the theory presented above, is that determining the optimal exemption on a state-by-state basis would have been too complicated for Congress, and it did better by, in effect, franchising exemption policy to the states.

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[195] *See id.* at 864–65 (testimony of Philip Schuchman, Law Professor, University of Connecticut); *id.* at 762 (David H. Williams, Federal Trade Commission).

[196] *Cf.* DYE, *supra* note 183, at 62 (observing that urban interests prefer national power to state power).

[197] This is Feidler's theory. *See* Feidler Interview, *supra* note 80.

[198] *See, e.g.*, *1975–76 House Hearings*, *supra* note 54, at 1369 (statement of Alvin O. Wiese, Jr., Chairman, Subcommittee on Bankruptcy, National Consumer Finance Association); *id.* at 1394 (statement of Jonathan J. Lindley, Director of Washington, D.C. Office, Credit Union National Association).

VII. BUSINESS REORGANIZATIONS

The legislative history of the Code contains a number of interesting conflicts over the law of corporate reorganization. It might surprise some people to learn that an argument that did not have much prominence is an argument currently used by many scholars to justify Chapter 11, namely that reorganization protects employees from the dislocation caused by economic and organizational transitions. A few parties raised this point in hearings in a desultory way,[199] and the 1977 House Report mentioned it briefly,[200] but it did not receive much attention or analysis, despite its populist appeal.[201]

An important issue in the legislative history, by contrast, concerned the question whether the streamlined, pro-management procedures of Chapter XI should govern reorganization of large, publicly held corporations. Recall that between the late 1930s and the enactment of the Code in 1978, Chapter XI had become the preferred means of reorganization even for the public corporations for which Chapter X had been intended. Creditors supported the debtors' Chapter XI filings, and courts generally went along, resisting the SEC's efforts to convert to Chapter X. Managers preferred Chapter XI because Chapter XI left them in control of the firm during reorganization and gave them the exclusive right to propose the plan of reorganization.[202] Chapter X required the replacement of the managers with a trustee. Managers could use their Chapter XI powers to keep the firm alive while hoping for a change in market conditions. To be sure, managers did not necessarily exercise their powers under Chapter XI. Studies of recent corporate bankruptcies show that managers rarely keep their positions after a firm enters bankruptcy,[203] and this was likely the case prior to 1978. But managers probably could use their Chapter XI powers to extract concessions from the creditors, such as pecuniary compensation or an equity interest in the reorganized firm.[204] Managers also probably liked Chapter XI's "best interests" standard, which guaranteed creditors only the liquidation value of their claims. If any going concern value remained, this could, in principle, be distributed to equityholders such as the managers. In contrast, Chapter X's absolute priority rule distributed going concern value to interests with the highest priority.

The managers' preference for Chapter XI might lead one to believe that the creditors preferred Chapter X. Although creditors could buy off managers in a Chapter XI proceeding and have a receiver appointed who would be more sensitive to the creditors' interests, surely creditors would have preferred Chapter X, because under Chapter X they did not have to pay the management to resign and they were entitled to the going concern value of the firm.

There are several reasons why creditors—or, at least, some creditors—nonetheless preferred Chapter XI to Chapter X.[205] First, Chapter X proceedings always took a long time, whereas Chapter XI proceedings were usually brief. Chapter X required a large number of formal hearings and reports. Chapter XI proceedings were informal. Chapter X required that the SEC review the plan of reorganization—a process that took a long time—and it permitted it a thousand other interferences. One source of irritation was the SEC's position that equityholders with fraud claims had a right to rescission and refund of the purchase price, giving them priority over creditors.[206] Creditors believed that the formal requirements of Chapter X and SEC participation produced delay, during which costs mounted and assets dwindled, without creating any offsetting benefits.

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[199] *See, e.g., 1977 Senate Hearings, supra* note 72, at 623 (statement of Philip A. Loomis, Commissioner, Securities & Exchange Commission).

[200] *See* H.R. REP. NO. 95-595, at 463–64 (1977).

[201] Another interesting point is that unions foresaw that firms would have an incentive under the new law to declare bankruptcy in order to reject collective bargaining agreements. *See 1975–76 House Hearings, supra* note 54, at 2425–26 (statement of Max Zimny, General Counsel, International Ladies Garment Workers Union, AFL–CIO); *id.* at 2437–38 (statement of Jeffrey Gibbs, Counsel, Industrial Union Department, AFL–CIO). Their demands for restrictions on rejection for that purpose were ignored.

[202] *See id.* at 1874–75 (statement of Harvey R. Miller, William J. Rochelle, Jr. and J. Ronald Trost, National Bankruptcy Conference).

[203] *See* Stuart C. Gilson, *Management Turnover and Financial Distress*, 25 J. FIN. ECON. 241 (1989).

[204] *See* Michelle J. White, *The Corporate Bankruptcy Decision*, J. ECON. PERSP., Spring 1989, at 129 (discussing the issue of managers' incentives to choose to go into bankruptcy and to choose between liquidation and reorganization).

[205] *See 1975 Senate Hearings, supra* note 71, at 450–51 (testimony of Richard Kaufman, National Association of Credit Management).

[206] For a critique, see John J. Slam & Homer Kripke, *The Interface Between Securities Regulation and Bankruptcy—Allocating the Risk of Illegal Securities Issuance Between Securityholders and the Issuer's Creditors*, 48 N.Y.U. L. REV. 261 (1973).

Second, participating creditors had more influence in Chapter XI than they did in Chapter X. The creditors could elect their own receiver to operate the firm under the procedures of Chapter XI—once they had obtained resignations from the managers—whereas they had to submit to the appointment of a trustee by the bankruptcy court under the procedures of Chapter X.[207] In Chapter X the SEC challenged trustees who had connections with management, monitored their administration of the estate, and opposed any procedures and arrangements that did not meet its standard of fairness.[208] Because the SEC and the bankruptcy court exercised greater supervision over Chapter X cases than over Chapter XI cases, participating creditors in Chapter X had less influence over the outcome of reorganization than they did in Chapter XI.

Third, the practical distinction between the best interests standard and the fair and equitable standard was small. At first sight, one might think that creditors would prefer Chapter X, because the absolute priority rule gave creditors the going concern value of the firm; in Chapter XI the creditors were guaranteed only the liquidation value of the firm. When, however, a firm had no going concern value, which was often the case, the different standards led to the same outcome. When going concern value existed, the lower standard of Chapter XI did not injure the participating creditors, because it was only a floor and they could use their influence to negotiate a larger distribution. It could hurt only the nonparticipating creditors. Finally, the requirement that plans be "fair and equitable," under *Case* v. *Los Angeles Lumber Products Co.*,[209] could not be avoided by consent, and this of course meant that creditors could not pay off insiders in Chapter X even when the latter could offer "new value."[210]

These latter points are crucial. The procedural differences between Chapter X and Chapter XI had a significant effect on the ability of parties to engage in opportunistic behavior. Chapter XI favored those parties who participated in the reorganization—namely, the managers and the large creditors. Shareholders and small creditors—such as consumers, employees, and trade creditors—would generally not participate, because when one's claim is small the cost of participation exceeds the expected gains.[211] Thus, in Chapter XI managers and large creditors could conspire to create a plan that transferred value to them from the small creditors and, if the firm was not insolvent, the nonmanagement shareholders.[212] Chapter X favored the small creditors and the nonmanagement shareholders, because the court and the SEC would guard their interests. To be sure, large creditors could potentially do better in Chapter X because of the absolute priority rule, but it appears that they did better by paying off managers, and freezing out nonmanagement equity and small debt under the quick and informal procedures of Chapter XI,[213] than by sharing with small debt and possibly with equity and enduring delay under the cumbersome procedures of Chapter X.

This view receives support from the legislative history. The large creditors participated vigorously, arguing that the new bankruptcy law should follow Chapter XI, not Chapter X, and have informal, flexible procedures even for bankruptcies of large, public corporations.[214] Small creditors were not organized, did not testify, and probably had little influence.

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[207] Creditors lobbied for control of the trustee in reorganization cases. *See, e.g., 1975 Senate Hearings, supra* note 71, at 428 (statement of the National Association of Credit Management). A representative of another creditors' association stated that creditors preferred Chapter XI to Chapter X, because creditors had less say in Chapter X. *See 1975–76 House Hearings, supra* note 54, at 1685 (testimony of K. Richard Kaufman, Assistant Secretary, Credit Managers Association of Southern California).

[208] *See supra* text accompanying notes 36–39.

[209] 308 U.S. 106 (1939).

[210] *See* Ayer, *supra* note 32, at 999–1001.

[211] For anecdotal evidence of the costs of serving on creditors' committees, see *Why Creditors Don't Want To Serve on Creditors' Committees*, 30 Bankr. Ct. Dec. (CRR) A1 (June 17, 1997).

[212] A recent example in the news is the ability of top managers of bankrupt corporations to preserve their pension plans while the employees' pension plans lose their value. *See* Diana B. Henriques & David Cay Johnston, *Managers Staying Dry As Corporations Sink*, N.Y. TIMES, Oct. 14, 1996, at A1. Although the article is not entirely clear, it appears that some managers use their bargaining power to negotiate for pension protection during reorganization.

[213] The existence of such behavior appears to underline the SEC's objections to the CB and the JB. *See 1975 Senate Hearings, supra* note 71, at 762–64. It is also the theory of the court in *Northern Pac. Ry. v. Boyd*, 228 U.S. 482 (1913).

[214] *See 1975–76 House Hearings, supra* note 54, at 1744 (prepared statement of Franklin Cole, Chairman of the Board, Walter Heller & Co., Chicago, Ill.); *id.* at 1810–35 (comments submitted by National Commercial Finance Conference, Inc.; testimony of Eli Silberfield, General Counsel, National Commercial Finance Conference, Inc.; testimony of Carroll Moore, Chairman, Committee on Legislation; testimony of Leon S. Forman, Chairman, Committee on Preferences, Liena

Besides the creditors, the most important groups to testify on reorganization were the lawyers' groups. Creditors' lawyers supported the Chapter XI-type procedures, probably in part because their clients supported them. But the lawyers—particularly lawyers for corporate debtors—had an additional reason to prefer Chapter XI to Chapter X:

> Unfortunately, by filing a chapter XI case not only does the debtor remain in possession, but the lawyer also remains in control. The lawyer can really control the progress of the proceedings. The lawyer has an awful lot to do with what happens in that chapter XI proceeding, and the lawyer for the debtor will be appointed the lawyer for the debtor in possession, and so he will remain, throughout, in a very active capacity in a chapter XI case. In a chapter X case that does not ordinarily follow.[215]

In Chapter X a trustee was appointed, and the lawyer would not earn a very large fee. So lucrative were the positions open to lawyers in reorganizations in Chapter XI that lawyers apparently engaged in misbehavior under the procedures of Chapter XI, particularly in their attempts to obtain control of creditors' committees.[216]

It is unclear whether Chapter X or Chapter XI better served the interests of shareholders, considered from an ex ante perspective. Chapter XI's "best interests" test gave them a better chance of obtaining some value from the reorganization than did Chapter X's requirement of a "fair and equitable" plan; but, as mentioned before, shareholders were unlikely to receive value under either test, since managers and creditors do not usually enter a solvent firm into bankruptcy. Shareholders may have feared, however, that managers would enter a solvent firm into bankruptcy in order to justify a capital restructuring that transferred wealth away from existing shareholders. If the speed of Chapter XI's procedures resulted in a lower cost of reorganization when reorganization was warranted, then shareholders would have preferred Chapter XI; but if the informality of Chapter XI's procedures enabled management to manipulate the process in its favor, then the shareholders could well have preferred Chapter X. That Chapter XI allowed management to have an interest in the reorganized entity was unlikely to benefit shareholders; as the SEC argued, there were more straightforward ways to pay for participation of management if such participation was necessary.[217] It seems likely that the optimal reorganization law for shareholders would have given less power to management than Chapter XI did—instead, giving power to an independent trustee, perhaps—while using less cumbersome procedures than those found under Chapter X. Whatever the case, shareholders did not have a sufficient stake to organize and played no role in the legislative history.[218]

As noted, managers would prefer Chapter XI procedures to Chapter X procedures, because the former allowed them to remain in control of the corporate debtor for a certain amount of time. Despite these benefits, managers did not testify.[219] One possible reason is that managers do not generally believe that their firms will ever go bankrupt; another possibility is that testimony in favor of pro-management provi-

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and Title, National Bankruptcy Conference). The bankers, while also strongly preferring the informal procedures of Chapter XI, would have allowed an exception for corporate reorganizations that would "materially and adversely affect" the rights of equity. *See 1975 Senate Hearings*, *supra* note 71, at 648 (recording the recommendations of the American Life Insurance Association, whose members are major creditors of corporations); *id.* at 493, 498–99 (statement of Joseph Patchan, partner at Baker, Hostetler & Patterson); *id.* at 1752 (statement of Robert J. Grimmig, American Bankers Association).

[215] *1975 Senate Hearings*, *supra* note 71, at 367 (testimony of Lawrence P. King, Associate Dean, New York University Law School, and consultant to the Bankruptcy Commission); *see also 1975–76 House Hearings*, *supra* note 54, at 1911 (testimony of William Rochelle, National Bankruptcy Conference); H.R. DOC. NO. 93–137, at 247 (1973).

[216] *See 1975 Senate Hearings*, *supra* note 71, at 444 (testimony of Larry Lawrence, National Association of Credit Management).

[217] *See id.* at 756 (prepared statement submitted by the Securities & Exchange Commission).

[218] The conventional wisdom is that shareholders have little political influence because they are not organized, and they are not organized because they have relatively little at stake. *See, e.g.*, Jennifer Arlen & Deborah M. Weiss, *A Political Theory of Corporate Taxation*, 105 YALE L.J. 325, 363–65 (1995). In the 1970s the law discouraged institutional investors from lobbying, and institutional investors had much less power than they do today. *See* Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445 (1991).

[219] Adler argues that corporate managers would resist efforts to amend the Bankruptcy Code in a way that would make it more favorable to shareholders. *See* Adler, *supra* note 7, at 343–45. *Cf.* F.11., Buckley, *The American Stay*, 3 S. CAL. INTERDISC. L.J., 733 (1994) (discussing political influences on the stay); Skeel, *supra* note 24, at 495–503 (criticizing Adler).

sions in bankruptcy would have been bad public relations.[220] The latter point suggests that managers might have exercised their influence behind the scenes.[221] However, corporations have never been shy about lobbying state legislators for protection from takeovers despite the risk of bad public relations.[222] Another possible reason is that the gain to managers from favorable reorganization law was just not that much relative to the cost of lobbying; in this sense, they may have been an unorganized and uninfluential group like the shareholders. But even if this were so, their interests and the interests of commercial bankruptcy lawyers converged, because the lawyers would want their clients—the managers—to find reorganization attractive so that they would enter reorganization as much as possible. The managers' interest in Chapter XI procedures for the reorganization of public corporations under the new bankruptcy law was thus reflected in the behavior of the lawyers, who vigorously lobbied for such provisions.[223]

The cleavage between the approaches of Chapter X and Chapter XI persisted throughout the legislative history of the Bankruptcy Code, and at every stage participants testified in conformity with their interests, as described above. Most observers agreed that reorganization of small, closely-held corporations should follow the informal approach of Chapter XI, because such corporations do not suffer from the distortions caused by the separation of management and equity. The chief dispute concerned whether the approach used for close corporations should also govern large, public corporations. This dispute was often unhelpfully phrased as the question of whether Chapters X and XI should be consolidated into a single chapter or should remain separate, but the real issue—the power to be given to managers of public corporations—is clearly discernable. Most of those who sought consolidation believed that Chapter XI procedures should control in cases involving public corporations. Everyone who resisted consolidation believed that rigorous procedures like those in Chapter X should control in cases involving public corporations. The consolidation language was rhetorically powerful, because a plea for simplification of the law always has resonance, but it did not affect the substance of the debate. Some participants advocated consolidation of the chapters but wanted the law to treat public corporations differently from close corporations; so they advocated consolidation of Chapters X and XI but with an exception for public corporations in the (single) chapter that would result.

The CB is a product of the last strategy. The Commission proposed consolidating the two chapters but creating special provisions for public corporations, albeit in a rather obscure way. Instead of the absolute priority doctrine implied by Chapter X's requirement of a "fair and equitable" plan and instead of the liquidation standard implied by Chapter XI's "best interests" test, the CB created a "fairness test" which had, according to the Commission, the following characteristics. The absolute priority rule would continue to be applied, but it would be softened by allowing "another look after the facts are in" (whatever that means) and by allowing equity to obtain some value if its future contributions, especially in the form of management, were thought essential to a successful reorganization. In addition, the court would not make the valuation necessary for this test if a public corporation was not involved and the parties, after full disclosure, negotiated a settlement.[224] The idea behind this odd evidentiary provision was that the protection of the absolute priority rule would drop away when everyone consented to a reorganization, but again only in the case of close corporations. The absolute priority rule with a new value exception would apply when public securities were involved. In addition, an independent trustee would be discretionary but presumptive for public corporations, and although the SEC's role would be eliminated, its functions would be performed by the bankruptcy agency. The Commission thus recognized the possibility of a greater conflict in public corporations between the interests of management, on the one hand, and creditors and shareholders, on the other, than in private corporations. This difference justified greater procedural protections for reorganization of public corpora-

[220] *See* Klee Interview, *supra* note 82.

[221] The Business Roundtable did apparently lobby behind the scenes. *See* Klee Interview, *supra* note 82.

[222] *See, e.g.*, Romano, *supra* note 5, at 122–26.

[223] *See 1975–76 House Hearings*, *supra* note 54, at 1539–40 (statement of Louis W. Levit, Chairman, Special Committee of the Judiciary, Commercial Law League) (note rejection of proposal of automatic subordination of manager claims); *id.* at 1657 (statement of L.E. Creel, III, Dallas Bar Association); *1975 Senate Hearings*, *supra* note 71, at 622 (statement of California Bar Association, Committee on Relations of Debtor and Creditor).

[224] This, in any event, is the Commission's description of the rule. *See* H.R. Doc. No. 93–137, at 258 (1977). A glance at the rule itself (§7–310(d)(2)(B)) does not disclose the basis of this description; the rule is too vague. *See 1975–76 House Hearings*, *supra* note 54, at 261 app.

tions than for reorganization of private corporations. Behind the rhetoric of consolidation, the two-track system prevailed.[225]

House Bill 8200 followed the CB in emphasizing the importance of consolidation and in providing for a modified absolute priority rule that allowed consenting senior creditors to give up some value to equity in return for cooperation. This idea is uncontroversial when applied to close corporations, where ownership and control are undivided, but its application to public corporations raised serious difficulties. The problem is that the modified absolute priority rule allows management of public corporations to extract value from creditors by threatening to delay reorganization and to extract value from small creditors by conspiring with large ones. Indeed, the Supreme Court had made this point repeatedly in its opinions on equity receiverships,[226] and again when it rejected an argument that the "fair and equitable test" of Chapter X permitted senior creditors to transfer value to managers in return for cooperation.[227] But House Bill 8200 did not, unlike the CB, provide the "evidentiary" restriction on reorganization of public corporations. House Bill 8200 did not differentiate public and private corporations at all. Moreover, House Bill 8200 further weakened the absolute priority rule by applying it to classes of creditors, rather than to every creditor, so a senior creditor would lose value to junior creditors if outvoted by other creditors in its class. House Bill 8200 also did not provide for an automatic trustee, and it denied standing to the SEC. In these ways, House Bill 8200's treatment of reorganization of public corporations followed the informal route of Chapter XI, even more so than did the CB, and in contradiction to prior law.

Senate Bill 2266, which maintained separate rules for public and private corporations, differed crucially from House Bill 8200 by forbidding management and creditors of public corporations to agree to a reorganization that locks out the shareholders and small creditors. Senate Bill 2266 endorsed the absolute priority rule in all its rigor. In particular, Senate Bill 2266 would have made confirmation of the plan depend on the court's finding that objecting classes (including equity) received adequate value. Senate Bill 2266 also provided for the automatic appointment of trustees for bankruptcies of public corporations, for standing for the SEC as the representative of unorganized shareholders and bondholders, and for a larger judicial role in valuing the business and assuring that the plan is fair. Whereas the House argued that shareholders were more sophisticated than they were when the Chandler Act was passed and could protect themselves as long as sufficient disclosure is made,[228] the Senate insisted that shareholders in public corporations had to be protected from attempts by managers and large creditors to freeze them out.[229]

What explains the House's and Senate's divergence over the formality of procedures for the reorganization of public corporations? One explanation draws on the observation that lawyers and large creditors supported informal procedures. The House's constituency consisted of the populous urban areas where large corporations, with many employees and vast financial resources, exercised their greatest influence. The corporations exercised their influence through their managers, and these managers had strong incentives to preserve their power, even at the expense of the shareholders they represented. When a firm enters bankruptcy, the managers would like to retain control as long as possible and to have as much leverage as possible with respect to the creditors. The reader will be reminded of the recent successful efforts of entrenched management to lobby state legislatures for takeover protection that benefited the management at the expense of the shareholders.[230] If managers exercised influence behind the scenes, they would have more influence over the House than over the Senate.

Also in the populous urban areas were the powerful banks and other large creditors, which, expecting to have large enough claims to find it worthwhile to participate in reorganizations, preferred rules that maximized the influence of participants over proceedings; and the lawyers, who preferred the informal procedures of Chapter XI, which maximized their business and their control over the proceedings. The Senate, by contrast, was disproportionately controlled by smaller, less populous

[225] The JB continued the separate tracks of the old law and appeared not to make many substantive changes. Because the bankruptcy judges did not feel strongly about this aspect of their bill, disclaiming their support for it at the first sign of opposition, *see 1975–76 House Hearings, supra* note 54, at 1184. I will ignore their views.

[226] *See* Northern Pac. Ry. v. Boyd, 228 U.S. 482 (1913); Louisville Trust Co. v. Louisville, New Albany and Chicago Ry., 174 U.S. 674 (1899).

[227] *See* Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106 (1939).

[228] The full explanation is confusing. *See* H.R. REP. NO. 95–595, at 222–24 (1977).

[229] *See* S. REP. NO. 95–989, at 9–10 (1978).

[230] *See* Romano, *supra* note 5 at 120–42.

states, where managers of big businesses, large creditors, and lawyers[231] existed in smaller numbers and had less influence.[232] Lacking influential constituents with a strong interest in management and big credit, senators may have been open to the influence of the SEC,[233] which supported stricter procedures and standards for reorganization of public corporations[234]—probably to protect its turf but probably also to protect public investors. Another possible explanation is that senators believed that protection of shareholders and junior debtholders was in the public interest,[235] though this hardly explains why members of the House did not take a similar view. More plausible, given the disproportionate influence of rural states in the Senate, is that the Senate's position reflected the populist fear of the power of vast public corporations, the same fear that produced Chapter X forty years earlier.[236]

The support for special protections in the case of public corporations was thus awfully thin, and it is not surprising that the Senate conceded almost completely to the House on these issues during the final negotiations. The final bill did not contain special distribution rules for public corporations, and it kept the House's watered-down absolute priority rule. Although the final language was not explicit on this issue, it appeared to contain the new value exception sought by the House.[237] The face-saving concessions to the Senate were meager: most notable, permission for the SEC to appear in bankruptcy court but not to appeal adverse orders, the automatic appointment of an examiner for the bankruptcy of public corporations, and the prohibition on issuing nonvoting stock.[238] The examiner could perform an investigation and issue a report on the debtor, but it did not have the standing or the coercive powers of the trustee. The interests of large creditors, the lawyers, and managers had prevailed over those of the shareholders and the small creditors, a result consistent with what appears to have been the distribution of political power.

VIII. MISCELLANEOUS

A. *Student Loans*

The Commission Report recommended that educational loans not be dischargeable in bankruptcy.[239] The recommendation apparently grew out of a concern that the increasing frequency of such discharges would undermine the student loan system. During the House and Senate hearings banks and other creditors, academic institutions, bankruptcy lawyers, bankruptcy judges, and several members of Congress testified in support of dischargeability.[240] No major interest groups opposed dischargeability, but several members of Congress testified in opposition to dischargeability. House Bill 8200 provided that educational loans would be dischargeable, as under the prior law.[241] Senate Bill 2266 provided that educational loans would not be dischargeable within five years of maturity. The final bill reflected the Senate's version.

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[231] That lawyers had more influence in the House than in the Senate is shown by their greater success in the House than in the Senate in obtaining provisions granting generous attorneys' fees in bankruptcy cases. The House prevailed on this issue in the final bill. *See* 124 CONG. REC. 33,994 (1978).

[232] This is a simplification. In some small states a few large creditors have disproportionate influence; for example, Aetna in Connecticut. *See* Romano, *supra* note 5 at 122–39.

[233] The SEC apparently had a powerful friend in Senator Roth. *See* Klee Interview, *supra* note 82.

[234] *See 1975 Senate Hearings, supra* note 71, at 732–33, 754–56 (summary of recommendations and statement of Securities & Exchange Commission).

[235] *See* S. REP. NO. 95–989, at 10 (1978).

[236] *See* Skeel, *supra* note 24.

[237] On this, see Ayer, *supra* note 32. *See also* Bonner Mall Partnership v. U.S. Bancorp Mortgage Co. (*In re* Bonner Mall Partnership), 2 F.3d 899 (9th Cir. 1993). *Norwest Bank Worthington v. Ahlers*, 484 U.S. 197 (1988), left the issue open.

[238] *See* 124 CONG. REC. 34,003–09 (1978).

[239] *See* H.R. DOC. NO. 93–137, at 12 (1973).

[240] *See 1977 Senate Hearings, supra* note 72, at 619 (supplemental statement of Commercial Law League); *1975–76 House Hearings, supra* note 54, at 981 (statement of Bankruptcy Judge Clive W. Bare); *id.* at 1029 (testimony of Walter W. Vaughan, Vice President, American Security Bank, and Chairman, American Bankers Association and Consumers Bankers Association Task Forces on Bankruptcy); *id.* at 1127–30 (statement of Clarissa Gilbert, President, U.S. National Student Association); *id.* at 1301 (statement of Bankruptcy Judge Joe Lee); *id.* at 1339 (statement of Paul L. Winkler, bankruptcy attorney); *id.* at 1368 (statement of Alvin O. Wiese, Jr., National Consumer Finance Association); *1975 Senate Hearings, supra* note 72, at 315, 329 (statement and testimony of Richard A. Hesse, National Consumer Law Center); H.R. REP. NO. 95–595, at 132 (1997). *But see 1975–76 House Hearings, supra* note 54, at 1394 (statement of Credit Union Association) (opposing dischargeability); *1975 Senate Hearings, supra* note 72, at 215–22 (statement of Sheldon Steinbach, American Council on Education).

[241] *See* H.R. REP. NO. 95–595, at 132–34.

Academic institutions benefited from dischargeability, because it transferred the burden of paying tuition from students to the government, artificially inflating the demand for education. Creditors benefited, because they earned interest on the loans but incurred no risk, because the government guaranteed the loans. Lawyers benefited, because recent graduates' main liabilities consisted of their student loans, and they had to hire lawyers in order to have them discharged. The victim of the dischargeability rule was the diffuse and unorganized public. However, the abuse of the system and the cost and unfairness to the taxpayer were clear enough that politicians could score points with voters by taking a public stand against dischargeability. The apparently opportunistic failure to pay debts, at the taxpayer's expense, was doubtless more readily comprehended and condemned by the average voter than the esoteric details of corporate reorganization and judicial administration. This may explain the unusually frequent testimony of members of Congress during the hearings. By testifying (and, of course, voting) in favor of nondischargeability, they created a record that would help them during their next election.[242] Members of Congress not directly influenced by constituents on this issue may also have feared the budgetary implications of the government's increasing liability for discharged student loans.[243]

B. The Fraud Exception To Discharge

The House and Senate agreed to retain the 1898 Act's exception to discharge for debts issued after debtors had filed false financial statements with creditors. As one might expect, creditors and their lawyers generally testified in favor of the exception; debtors' lawyers testified in opposition of the exception.[244] The latter argued that creditors abused the fraud exception in two ways. Some creditors would give consumer debtors highly complex financial forms to fill out in the hope that the complexity would lead to mistakes, the mistakes could be represented as intentional misrepresentation, and thus the debt would be made nondischargeable. Creditors would also threaten to sue debtors for fraud in the hope of extracting from them a reaffirmation of their debts.[245] The Commission had taken these claims seriously and recommended that the exception be eliminated.[246] However, Congress compromised between the interests by adding some fee-shifting provisions designed to compensate debtors who litigate false claims of fraud.

C. Reaffirmation

Under the 1898 Act a debtor could reaffirm any debts dischargeable in bankruptcy. Debtors' lawyers, the FTC, and many academics opposed the right to reaffirm, arguing that creditors obtained reaffirmations through bullying and deception, thus depriving the debtor of a fresh start.[247] Creditors and creditors' lawyers supported reaffirmation, no doubt because it reduced their bankruptcy losses a great deal. But they also made the plausible argument that the debtors themselves benefited from the right to reaffirm, as it enabled them to acquire new credit and to retain valued collateral.[248] No one has noticed that a prohibition on reaffirmation would discourage debtors from filing for bankruptcy: by reducing their ability to obtain credit after bankruptcy, such a prohibition would make bankruptcy less attractive. The final law permitted reaffirmation, but also required approval by the bankruptcy court and established a thirty-day cooling-off period during which the debtor could unilaterally rescind the reaffirmation.

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[242] *See, e.g., 1975–76 House Hearings, supra* note 54, at 1087–94 (Rep. John N. Erlenborn, Illinois); *id.* at 1098–1127 (Rep. Edwin D. Eshleman, Pennsylvania); 124 CONG. REC. 1791–93 (Rep. Allen E. Ertel, Pennsylvania).

[243] *See generally* H.R. REP. NO. 95–595, at 536–38 (supplemental views of Rep. Ertel).

[244] *See, e.g., 1975–76 House Hearings, supra* note 54, at 970 (testimony of Bernard Shapiro, California attorney) (noting that the National Bankruptcy Conference opposes exception); *id.* at 897–902 (statement of Linn K. Twinem, attorney, Beneficial Finance System) (supporting exception); *id.* at 923–25 (statement of Benjamin L. Zelenko, creditors' lawyer) (supporting exception); *cf. id.* at 891–93 (testimony of Phillip Shuchman, Law Professor, University of Connecticut).

[245] *See* H.R. REP. NO. 95–595, at 130–31.

[246] *See* H.R. DOC. NO. 93–137, at 176 (1973).

[247] *See, e.g., 1975–76 House Hearings, supra* note 54, at 943 (statement of Ernest L. Sarason, Jr., National Consumer Law Center); *id.* at 762–63 (statement of David H. Williams, attorney, Bureau of Consumer Protection, Federal Trade Commission); *id.* at 873 (testimony of Philip Shuchman, Professor of Law, University of Connecticut).

[248] *See, e.g., id.* at 902–03 (statement of Linn K. Twinem, attorney, Beneficial Finance System); *id.* at 1023 (statement of Walter W. Vaughan, Vice President, American Security Bank; and Chairman, American Bankers Association and Consumers Bankers Association Task Forces on Bankruptcy).

CONCLUSION

The dominant academic view of the Bankruptcy Code is that it works well. This view is not hard to understand. The Bankruptcy Code is in many respects an elegant and sophisticated piece of legislation. The 1898 Act had become intolerably ambiguous and archaic, really quite horrible, and the 1978 Act swept away the years of doctrinal cobwebs and incrustations, replacing them with a lucid, simple, and apparently humane system for dealing with overburdened debtors and helpless corporations.

The academic view, however, makes a typical lawyerly mistake: it confuses improvement in doctrine with improvement in policy. That post-1978 doctrine is clearer and simpler than pre-1978 doctrine does not mean that it better serves the public interest. Indeed, measured by the standards set for itself by the 1973 Commission, the Bankruptcy Code must be considered a failure.

Recall that the Commission listed the following complaints with the old system: (1) the rapid increase in the rate of bankruptcy filings (208,329 filings in 1967); (2) administrative waste; (3) insufficient generosity for debtors and failure by creditors to collect in bankruptcy; (4) lack of uniformity in the treatment of debtors; and (5) negligence and abuse on the part of bankruptcy professionals.[249] The 1978 Act has not solved these problems. First, as discussed in more detail below, since 1978 bankruptcy rates have skyrocketed to over one million per year. Second, the efficiency of the current bankruptcy system is doubtful. From July 1, 1990, to June 30, 1992, for example, the total cost of the 1.2 million consumer chapter 7 cases exceeded gross receipts in these cases by almost $100 million and distributions to creditors by about $250 million.[250] Third, exemption laws are more generous today than they were before 1978, but the generosity of exemptions is mostly a matter of state law. There are no statistics on the extent to which creditors use the bankruptcy system rather than swallowing losses from unpaid loans. Fourth, because of the role of state exemption law in the Bankruptcy Code, debtors continue to be treated nonuniformly. Fifth, although anecdotal evidence suggests that negligence and abuse are less widespread today than prior to 1978, the lack of systematic evidence of this behavior both now and then makes generalization hazardous.

Now, it is doubtful that the 1973 Commission's rather haphazard list of complaints about the old law should be the standard for evaluating the Bankruptcy Code, and the statistics *should* be read carefully. One might criticize a private company that spent almost twice as much money to collect from debtors than it received from them, but the Bankruptcy Code's goals are more complicated. The pertinent question is whether, supposing the goals are proper, some other system would achieve them more cheaply. The answer to this question would take us beyond the scope of this paper. A more modest approach to bankruptcy reform draws on this article's conclusions about the political history of the 1978 Act. We can use these conclusions to evaluate complaints recently directed at that law and ask about the nature and likelihood of reform.

Consumer bankruptcy filings and exemptions. Many commentators worry about the rapid growth of consumer bankruptcies since 1978. Recall that the 1973 Commission had mentioned as a reason for bankruptcy reform the growth of bankruptcy filings from 10,196 in 1946 to 208,329 in 1967.[251] In 1996 bankruptcy filings exceeded 1 million. One can obtain a more accurate sense of the trend by observing that from 1920 to 1960, between about 1 in 2000 and 1 in 4000 people filed for bankruptcy, with no clear trend up or down. There was an anomalous dip in the mid-1940s, probably as a result of post-war prosperity. From 1960 to 1978, there was a gradual upward trend in filings, from about 1 in 2000, to about 1 in 1000. From 1978 to 1996, filings increased from 1 in 1000 to about 1 in 270.[252] A recent study suggests that a considerably larger portion of the population, ranging from fifteen percent to twenty-three percent, would benefit financially from filing for bankruptcy,

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[249] *See supra* text accompanying notes 46–50.

[250] *See* GENERAL GOVT. DIV. U.S. GEN. ACCOUNTING OFFICE, PUB. NO. GAO/GGD 94–173, BANKRUPTCY ADMINISTRATION: CASE RECEIPTS PAID TO CREDITORS AND PROFESSIONALS, at 34 tbl.II.2 (1994). For consumer bankruptcies, gross receipts were $427.4 million, creditor distributions were $273.6 million, total costs were $521.3 million—including bankruptcy court costs and trustee and debtor attorney compensation, but not apprently including creditors' lawyers. For business bankruptcies, gross receipts were $1.5 billion, creditor distributions were $929 million, and total costs were $461 million. *See id.*

[251] *See* H.R. DOC. No. 93–137, at 2.

[252] These statistics are published every year. *See, e.g.*, JUDICIAL CONFERENCE OF THE U.S., ANNUAL REPORT OF THE DIRECTOR OF THE ADMINISTRATIVE OFFICE OF THE UNITED STATES COURTS 117–21 (1978). For a compilation of statistics, see Joseph Pomykala, *The Division and Destruction of Value: An Economic Analysis of Bankruptcy Law*, at app. E & F (1997) (unpublished Ph.D. dissertation, University of Pennsylvania) (on file with author).

and even larger portions would benefit if individuals engaged in sophisticated prebankruptcy planning.[253] Although academics disagree about the extent to which the increase in filings reflect the influence of the Bankruptcy Code,[254] it is clear that if the quantity of bankruptcy filings was a problem in the 1960s, the Code has not solved it.

One explanation for the increase in the filing rate is the rise in the generosity of state exemptions. There is, however, little evidence for this view. But even if the view were correct, Congress can do little about exemptions, as they are determined by state law. Although some creditors and commentators advocate uniform federal exemptions, it is no more likely that Congress can preempt state exemption laws today than it could in 1978. Indeed, given recent trends in the devolution of power from the federal government to the states, a system of uniform federal exemptions appears more unlikely now that it did in the 1970s. A further irony should be observed. Most of the states that opted out of the federal exemptions in 1979 and the early 1980s did so in order to force debtors to use stingier state exemptions;[255] but now many—possibly most—of the opt-out states provide for exemptions that are more generous than federal exemptions. The National Bankruptcy Review Commission will recommend a system of uniform federal exemptions for some property and floors and ceilings on state exemptions with respect to other property.[256]

Double appeals. Bankruptcy litigants must appeal adverse rulings to the district court, and from there to the circuit court and the Supreme Court. Commentators criticize this rule, seeing little reason to believe that bankruptcy disputes need three levels of appeal when ordinary civil disputes need only two. We have seen that this system is an artifact of the federal judiciary's attempt to maintain their prestige prior to 1978. The double appeal system was a concession to the federal judges, a symbol of the subordination of the bankruptcy court to the district court. Assuming that the federal judiciary no longer would exert political pressure on this issue (as seems plausible), the system will probably be abolished, as it should be. The NBRC has voted to eliminate the double appeals system.[257]

Article III standing for bankruptcy courts. The NBRC will recommend that bankruptcy courts be given Article III status.[258] It will be interesting to see whether the federal judiciary will raise objections again. Because the bankruptcy judiciary has become more respectable, the federal judiciary might see in its elevation less of a threat to its status than in 1978. Even if federal judges raise objections to the elevation of bankruptcy judges, jurisdictional confusion and other difficulties raised by the bankruptcy courts' awkward position in the judiciary may cause Congress to ignore such objections.

The U.S. Trustee System. In a recent survey of the members of the American Bankruptcy Institute, the U.S. Trustee System was most frequently listed in response to a question asking for the three most important problems in the bankruptcy system.[259] Although the survey does not supply the reasons for the respondents' dissatisfaction, other sources suggest that bankruptcy lawyers think that the U.S. Trustees do not appoint trustees in a fair way, possibly engaging in cronyism; intervene in cases on the basis of their publicity, rather than on the basis of the merit of the intervention; object to reasonable legal practices; do not perform adequate supervision; issue inappropriate guidelines that do not take account of local

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[253] *See* Michelle J. White, Why Don't More Households File for Bankruptcy? (1996) (unpublished manuscript, on file with author).

[254] See William J. Boyes & Roger L. Faith, *Some Effects of the Bankruptcy Reform Act of 1978*, 29 J.L. & ECON. 139 (1986); Ian Domowitz & Thomas L. Eovaldi, *The Impact of the Bankruptcy Reform Act of 1978 on Consumer Bankruptcy*, 36 J.L. & ECON. 803 (1993); Richard L. Peterson & Kiyomi Aoki, *Bankruptcy Filings Before and After Implementation of the Bankruptcy Reform Law*, 36 J. ECON. & BUS. 95 (1984); Lawrence Shepard, *Personol Failures and the Bankruptcy Reform Act of 1978*, 27 J.L. & ECON. 419 (1984); Alden F. Shiers & Daniel P. Williamson, *Nonbusiness Bankruptcies and the Law: Some Empirical Results*, 21 J. CONSUMER AFF. 277 (1987); Michelle J. White, *Personal Bankruptcy Under the 1978 Bankruptcy Code: An Economic Analysis*, 63 IND. L.J. 1 (1987); F.H. Buckley & Margaret F. Brinig, The Bankruptcy Puzzle (Jan. 24, 1996) (unpublished manuscript, on file with author). Reint Gropp et al., *Personal Bankruptcy and Credit Supply and Demand*, 62 Q.J. ECON. 217 (1997), presents evidence that generous exemptions restrict credit to low-asset households and expand credit to high asset households.

[255] *See* TERESA A. SULLIVAN ET. AL., AS WE FORGIVE OUR DEBTORS 44 n.23 (1989).

[256] *See Commission Endorses Uniform Federal Exemptions Proposal*, 30 BANKR. CT. Dec. (CRR) A11 (June 3, 1997).

[257] See *Why the Commission Supports Change in Appellate Structure*, 29 Bankr. Ct. Dec. (CRR) A5 (Jan. 14, 1997).

[258] *See Commission Votes on Tough Issues, Picks Up Momentum*, 6 Consumer Bankr. News (CRR) 6, 7 (Jan. 16, 1997).

[259] *See ABI Releases Final Results of Bankruptcy Survey Part I: Overview/Business Reorganization Issues*, 29 Bankr. Ct. Dec. (CRR) A3, A3 (Jan. 14, 1997).

variations in legal culture and practice; and have little influence over bankruptcy judges.[260] Accusations (and admissions) of patronage in the system were mentioned earlier. Many of these problems can be traced to the centralization of an institution whose purpose is inherently local. The political history of the 1978 Act gives reason to doubt that the current system is desirable. It is possible that bankruptcy judges who hold office today would appoint trustees more honestly than the pre-1978 judges and than the current Trustees.[261]

The bankruptcy judge's administrative powers. Some commentators have argued that bankruptcy judges should have greater administrative powers than they do under the 1978 Act.[262] Recall that the elimination of the bankruptcy judges' administrative powers under the 1898 Act may have been motivated by the desire to enhance their status. It was thought that because an administratively engaged judge would look like a participant, he or she would appear to take sides and not to have the dignified cloak of impartiality. Whether or not this is true, the political motivation behind the separation of administrative powers and the normative justification should be kept separate, and the legal distinction rethought.

The debtor-in-possession model and the absolute priority rule. Many commentators believe that managers have too much control over the corporate debtor during reorganization.[263] Some object to the difficulty of replacing incompetent managers with trustees;[264] others object to the exclusivity period.[265] We saw that large creditors prefer to deal with managers rather than trustees, that lawyers also prefer to keep managers in control during reorganization, and that these groups made their influence felt during negotiations over the new bankruptcy law. Because the amount of authority given to managers during reorganization reflected the balance of political power and not necessarily the public interest, modification of the debtor-in-possession rules may be justified. A similar point can be made about the current version of the absolute priority rule: it more likely reflects the interests of the creditors and lawyers who lobbied Congress in the 1970s than the interest of the public.

Reaffirmation. There still exists a conflict between those who support and those who oppose the right to reaffirm debts. The 1978 Act's compromise—the cooling-off period and the requirement of judicial approval—appears to be routinely circumvented. Debtors reaffirm their debts outside the bankruptcy proceeding, and state courts enforce the reaffirmation when debtors breach the contract.[266] It is unsurprising that a last-minute political compromise would not take into account this difficulty of coordination in a federal system. If circumvention is in fact routine, the restrictions on reaffirmation should either be dropped or strengthened, depending on one's view about the value of reaffirmations.

* * *

Some readers might take this political history of the 1978 Act as an indication of the futility of legislative reform. If politics determines legislative outcomes, what is the purpose of reform? But such pessimism is unjustified. The lessons of the analysis are concrete and practical. Because of the indeterminacy of the normative arguments for and against various kinds of bankruptcy reform, one must rely on experience and history. The experience of lawyers and courts tells us which parts of the law create practical difficulties. History tells us which parts of the law reflect political compromises rather than normative goals. Because the political forces that led to unsatisfactory compromises in 1978 have changed, there is hope that proper amendments can now be made. But it must also be acknowledged that reformers face a new set of political forces in 1997, and these forces will limit the extent to which improvement can be achieved.

Mr. CHABOT [presiding]. Thank you very much.

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[260] *See, e.g.*, Levin & Klee, *supra* note 28, at 4–5: *Why Is the U.S. Trustee Program Such a Lightening Rod?*, 29 Bankr. Ct. Dec. (CRR) A1 (Oct. 22, 1996); *see also* Peter C. Alexander, *A Proposal to Abolish the Office of the United States Trustee*, 30 U. MICH. J.L. REV. 1 (1996); Linda J. Rusch, *Unintended Consequences of Unthinking Tinkering: The 1994 Amendments and the Chapter 11 Process*, 69 AM. BANKR. L.J. 349, 354 & n.31 (1995) (citing cases in which courts ciritize the U.S. Trustee's appointments).

[261] *See* GENERAL GOVT. DIV., U.S. GEN. ACCOUNTING OFFICE, *supra* note 119.

[262] *See, e.g.*, Steven W. Rhodes, *Eight Statutory Causes of Delay and Expense in Chapter 11 Bankruptcy*, 67 AM. BANKR. L.J. 287, 311–15 (1993).

[263] *See, e.g.*, *Should Debtors Have to Prove a Trustee Is Not Needed?*, 29 Bankr. Ct. Dec. (CRR) A3, A3 (Dec. 3, 1996).

[264] *See id.*

[265] *See Give the Commission a Piece of Your Mind*, 29 Bankr. Ct. Dec. (CRR) A1, A14 (Oct. 15, 1996).

[266] *See Commission and NCBJ Examine Consumer Bankruptcy Issues*, 6 Consumer Bankr. News (CRR) 1, 7 (Nov. 21, 1996).

Professor Skeel?

STATEMENT OF DAVID A. SKEEL, JR., PROFESSOR, UNIVERSITY OF PENNSYLVANIA LAW SCHOOL, PHILADELPHIA, PA

Mr. SKEEL. Thank you, Mr. Congressman.

I would like to give a very brief overview of the history of bankruptcy law over the last 100 years. I will focus in particular on the influence that bankruptcy lawyers have had on bankruptcy law, and on its implications for the current deliberations.

Although Congress passed several bankruptcy laws during the 19th Century, America did not have a permanent bankruptcy law until 1898. The driving force behind the 1898 Act was creditors. Business organizations, such as chambers of commerce and local boards of trade had begun to form in the late 19th Century, and under the auspices of an umbrella group they called the National Convention of Commercial Bodies of the United States, creditors pushed for a Federal bankruptcy law throughout the 1880's and 1890's. Business groups wanted a Federal bankruptcy law because they believed that State laws enabled debtors to discriminate against out-of-state creditors.

Creditors were fiercely opposed by a group of lawmakers, many of whom represented southern and western States, who feared that Federal bankruptcy laws would hurt farmers and that the administration of bankruptcy would require a vast new Federal bureaucracy. The 1898 Bankruptcy Act represented a compromise between these two perspectives. The law was passed, but the law also made it relatively easy for debtors to discharge their debts and pared down the administrative structure to an absolute minimum.

Perhaps the most important effect of the 1898 Act was that its scaled down administrative structure created an enormous need for a bankruptcy bar. In striking contrast to English bankruptcy law, the U.S. system was run by the parties rather than a governmental official. The judges, for instance, called referees, were part-time officials and had only limited powers, and each of the parties themselves relied on lawyers.

The next major movement to reform bankruptcy law commenced in 1929 with an extensive investigation that led to the Donovan Report in 1931 and to proposed legislation the following year. The report expressed concern with the behavior of bankruptcy lawyers, and in terms that sound much like the current debate, worried that bankruptcy law did not do enough to encourage debtors to pay their debts.

To remedy these concerns, the investigators called for Congress to appoint administrators to examine debtors, as in England, and suggested that discharge should be postponed in some cases; in effect, an earlier version of means testing.

The most strident opposition to these proposals came from bankruptcy lawyers. Speaking on behalf of groups such as the Commercial Law League and the Bankruptcy Committee of the American Bar Association, bankruptcy lawyers attacked the proposals claiming that there was no need to overhaul existing practice. Their opposition appears to have been an important reason that the principal reforms were abandoned. The influence of the general bankruptcy bar was further evidenced several years later in the most important New Deal bankruptcy reform, the Chandler Act of 1938.

Although the Chandler Act completely reformed the reorganization procedures for large corporations, the reformers deferred to the proposals of the general bankruptcy bar with respect to the rest of bankruptcy practice.

Bankruptcy lawyers are only one of the many groups with an interest in bankruptcy law, of course. Creditors continue to vigorously promote their interests as we have also seen in recent years, but bankruptcy lawyers have proven disproportionately influential for several reasons.

First, bankruptcy lawyers have an ongoing interest in bankruptcy law that is as great or greater than that of any other constituency. Creditors, for instance, can pass on some of the costs of bankruptcy to their customers.

Second, bankruptcy is extraordinarily complicated. Some might even say dull. Bankruptcy lawyers are the experts, and this expertise gives them substantial influence over the shape of the technical details of bankruptcy.

Many of the amendments that bankruptcy lawyers have supported over the years seem quite desirable, but bankruptcy lawyers, even those who represent creditors, have a strong interest that there be many bankruptcies rather than few. The two most striking trends in bankruptcy over the course of this century are that the scope of the bankruptcy laws has continually expanded, and that proposals that would reduce the need for bankruptcy lawyers often fail.

[The prepared statement of Mr. Skeel follows:]

PREPARED STATEMENT OF DAVID A. SKEEL, JR., PROFESSOR, UNIVERSITY OF PENNSYLVANIA LAW SCHOOL, PHILADELPHIA, PA

BANKRUPTCY IN U.S. HISTORY: THE PAST AND ITS IMPLICATIONS

I would like to give a very brief overview of the history of bankruptcy law over the last one hundred years. I will focus in particular on the influence that bankruptcy lawyers have had on bankruptcy law, and its implications for the current deliberations.

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Creditors were fiercely opposed by a group of lawmakers, many of whom represented southern and western states, who feared that federal bankruptcy laws would hurt farmers, and that the administration of bankruptcy would require a vast new federal bureaucracy. The 1898 Bankruptcy Act represented a compromise between these two perspectives. The law was passed, but the law also made it relatively easy for debtors to discharge their debts; and pared down the administrative structure to an absolute minimum.

Perhaps the most important effect of the 1898 Act was that its scaled down administrative structure created an enormous need for a bankruptcy bar. In striking contrast to English bankruptcy law, the U.S. system was run by the parties rather than a governmental official (the judges, called "referees" were part-time officials and had only limited powers), and each of the parties relied on lawyers.

The next major movement to reform bankruptcy law commenced in 1929, with an extensive investigation that led to the Donovan Report in 1931, and to proposed legislation the following year. The Report expressed concern with the behavior of bankruptcy lawyers and—in terms that sound much like the current debate—worried that bankruptcy law did not do enough to encourage debtors to pay their debts. To remedy these concerns, the investigators called for Congress to appoint administrators to examine debtors, as in England, and suggested that discharge should be postponed in some cases—in effect, an earlier version of means testing.

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Bankruptcy lawyers are only one of the many groups with an interest in bankruptcy law, of course. Creditors continue to vigorously promote their interests, as we have also seen in recent years. But bankruptcy lawyers have proven disproportionately influential for several reasons. First, bankruptcy lawyers have an ongoing interest in bankruptcy law that is as great, or greater, than that of any other constituency. Creditors, for instance, can pass on some of the costs of bankruptcy to their customers. Second, bankruptcy is extraordinarily complicated—some might even say boring. Bankruptcy lawyers are the experts, and this expertise gives them substantial influence over the shape of the technical details of bankruptcy.

Many of the amendments that bankruptcy lawyers have supported over the years seem quite desirable. But bankruptcy lawyers (even those who represent creditors) have a strong interest that there be many bankruptcies rather than few. The two most striking trends in bankruptcy over the course of this century are that the scope of the bankruptcy laws has continually expanded, and that proposals that would reduce the need for bankruptcy lawyers often fail.

I provide a more detailed discussion of each of the issues I have mentioned in two articles that I would more than happy to submit for the record: "Bankruptcy Lawyers and the Shape of American Bankruptcy Law," 67 Fordham Law Review 497 (1998); and "The Genius of the 1898 Bankruptcy Act," Bankruptcy Developments Journal (forthcoming, 1999).

BIO

David Skeel is a Professor of Law at the University of Pennsylvania. Professor Skeel graduated in 1987 from the University of Virginia School of Law, where he was an editor of the Virginia Law Review and a member of Order of the Coif. Thereafter, he clerked for the Honorable Walter K. Stapleton on the U.S. Court of Appeals for the Third Circuit, and practiced bankruptcy for several years at Duane, Morris & Heckscher in Philadelphia. Before joining the faculty of the University of Pennsylvania Law School, he taught at Temple University School of Law from 1990–1998. Professor Skeel also has held visiting appointments at the University of Wisconsin Law School and University of Virginia School of Law. Professor Skeel's recent articles include "Bankruptcy Lawyers and the Shape of American Bankruptcy Law,— 67 Fordham Law Review 497 (1998) and "The Genius of the 1898 Bankruptcy Act," Bankruptcy Developments Journal (forthcoming 1999).

Mr. CHABOT. Thank you, Professor.

Professor King?

STATEMENT OF LAWRENCE P. KING, CHARLES SELIGSON PROFESSOR OF LAW, NEW YORK UNIVERSITY SCHOOL OF LAW, NEW YORK, NY

Mr. KING. Thank you very much, and I thank the committee for the invitation to appear here today.

Since part of what I was going to talk about had also to do with some historical aspects of the bankruptcy law, I will pick up from what the good professor to my right was just talking about, except that I will limit my remarks more to the evolvement, if you will, of the discharge under the bankruptcy system that we have in the United States.

Of course, as everybody knows, we have what is called the unconditional discharge in the Bankruptcy Code, and that first came into existence, in its present form in the Bankruptcy Act of 1898. Until that time, even though Congress had the constitutional authority to enact the bankruptcy law, it really did not exercise that authority basically until 1898.

It did exercise it by enacting three laws prior to 1898, but these laws had very short existence. In 1800, it lasted for about 2 years. In 1841, it lasted for another couple of years, and the Act of 1867 lasted about 11 years. Throughout that process, too, the discharge itself evolved.

The first Act, for example, in 1800, was not even open to what we would call today consumers. It was available to traders and merchants only, and it was available only by means of involuntary petitions filed by creditors against the merchants and traders. In essence, it followed the English system that existed at that time. It was not possible to get a discharge at that time unless a certain percentage of creditors agreed to give it.

In 1841, for the first time, the bankruptcy law was open to what we would call consumers. That is all individuals, not just traders and merchants, and also it was available by means of a voluntary petition.

The discharge at that point was turned around somewhat. Instead of a percentage of creditors having to consent to the discharge, the creditors or a percentage of them in order to bar a discharge had to vote against it, which, of course, turned things around. So it was almost like an unconditional discharge at that time.

The Act of 1867 was still different with respect to the discharge and, in that Act, discharge became available only if a certain percentage of the debt was paid, or if a certain percentage of creditors agreed to it. So, as I say, until 1898, actually there was not the unconditional discharge that we have today.

Now, during this period of time, the law was evolving in England as well, and in England, the law that started then and exists to this day is what we would call the conditional discharge. That is, the judge has the discretion to suspend the discharge or to condition it, that is, for a period of time while payments are being made, or to condition it on the payment of a certain amount of debt over a period of time.

As mentioned, Congress did not opt for the English system in respect to the Act of 1898, even though back at that time, some of the same importuning by creditors was existing, and it is funny to say in a way, as exists today. There is not really a change in substance of the arguments that are being made.

One of the interesting factors, I think, that one ought to keep in mind, too, I just came across it very recently as a matter of fact, and it is a recent development. Germany had a law similar to England, that is, the conditional discharge. Interestingly, that law was abolished. On January 1st of 1999, with respect to the new German bankruptcy or insolvency law, they have adopted, as a model, the U.S. law. They have adopted the unconditional discharge and done away completely with what was considered to be the conditional discharge.

A problem existed in England, at least so I was told, I unfortunately cannot document it, and in Germany, of which I certainly have been told because I dealt a little bit with some of the legislators there. One of the aspects of having a conditional discharge meant that many, many people could not afford to make the payments, parenthesis, Chapter 13—could not afford to make the payments in order to get the discharge. How do they continue to live? The way they continue to live and to earn a living for their families was to move. In effect, it was to adopt a new identity, not to leave the country.

There are countries in the world where people leave the country because they cannot get a discharge. In others they would move to other parts of the country and in effect adopt another identification, another ID card, as we would call it, perhaps, another Social Security card, to get benefits and the like. I do not know if that is the kind of system that one would want to have here.

As I say, the importuning with respect to changing the unconditional discharge that we have and to go to a means-testing or to make Chapter 13 mandatory started back in the 1920's. It went through the 1930's, through the 1940's, through the 1960's, through the 1970's, through the 1980's.

I see my time is up, and let me just add one point. Back in the early 1920's and in the 1970's, there was this statement in the Congress and by Congressmen. One of the problems with the Bankruptcy Act is that the stigma of bankruptcy is decreasing.

Well, my goodness, if it has been decreasing since 1920 and here we are in 1999, how come there is any stigma left? I think there really is a major stigma left.

[The prepared statement of Mr. King follows:]

PREPARED STATEMENT OF LAWRENCE P. KING, CHARLES SELIGSON PROFESSOR OF LAW, NEW YORK UNIVERSITY SCHOOL OF LAW, NEW YORK, NY

PART I: NEEDS BASED BANKRUPTCY RELIEF: AN HISTORICAL PERSPECTIVE.

It is not clear what "Needs based bankruptcy relief" means, particularly in a historical context. In this Congress, the term is associated with the consumer credit industry's means testing proposal allowing an individual debtor to obtain relief under chapter 7 of the Bankruptcy Code only if the debtor cannot pay a portion of his debts under a set formula. Our current bankruptcy law offers a different interpretation of "needs based bankruptcy relief:" a system granting an unconditional discharge to nearly all honest individuals who forfeit their nonexempt property and accept the often painful consequences of declaring themselves bankrupt. This unconditional discharge concept evolved during the 19th century through Congressional acts exercising the bankruptcy power in the Constitution, which has culminated in bankruptcy laws considered the most progressive in the world. My testimony will review the history of both interpretations of needs based bankruptcy, but in reverse order. First, I will trace the development of the unconditional discharge. Second, I will provide an overview of requests made by the consumer credit industry and others throughout this century for a conditional discharge or means testing.

PART II: THE HISTORICAL DEVELOPMENT OF THE UNCONDITIONAL DISCHARGE, THE CURRENT SYSTEM'S VERSION OF "NEEDS BASED BANKRUPTCY RELIEF."

Throughout the history of bankruptcy legislation in the United States, bankruptcy law gradually changed from punishment and a creditor remedy, complete even with imprisonment for debt in the various States, to a more balanced approach that recognized not only that honest debtors deserve relief from the burden of oppressive indebtedness, but that providing a discharge for such individuals was sound public policy. See Hanover Nat'l Bank. v. Moyses, 186 U.S. 192 (1902)("determination of the status of the honest and unfortunate debtor by his liberation from encumbrance on future exertion is a matter of public concern").

Although the Constitution authorizes Congress to enact uniform laws of bankruptcy, our early national bankruptcy laws were short-lived and responsive to financial crises. The first bankruptcy law enacted by Congress was the Act of 1800, which was to expire of its own accord in 1805 but, in fact, was repealed in 1803. It resembled the English bankruptcy law at that time, applied only to traders and merchants, and had no provision for a voluntary petition, permitting only creditors to institute proceedings. A discharge was available only if two-thirds in number and value of the creditors consented. 1 Collier on Bankruptcy ¶0.04 (14th ed. 1974).

The next Act was passed in 1841. Under this Act, voluntary proceedings were possible for both merchants and nonmerchants. Discharge was available unless a majority in number and amount of creditors affirmatively dissented. See Vern Countryman, "A History of American Bankruptcy Law," Comm. L.J. 226, 229 (June/July 1976). The 1841 Act was repealed in 1843.

Economic difficulties after the Civil War produced the Act of 1867. Under this Act, discharge was available if a 50% dividend was paid or if a majority of creditors consented. See Collier, *supra* at 9; Countryman, *supra*, at 231; Charles Jordan Tabb, "The History of the Bankruptcy Laws in the United States," 3 ABI L. Rev. 5, 20 (1995). The Act of 1867 was repealed in 1878.

While Congress was enacting and repealing bankruptcy laws, English law also was evolving, particularly in the late 1800s. Like the Bankruptcy Act of 1898 in the United States, an English law revision in 1883 established the bankruptcy system there for many decades. English law gave the court discretion to grant or deny the discharge, and, most importantly, enabled the court to condition or suspend the discharge until a certain percentage of the debt was repaid out of future income. Our Bankruptcy Act of 1898 took a different approach and permitted the bankrupt to apply for an unconditional discharge, which would be denied on objection if the bankrupt had committed an act warranting the denial of a discharge, similar to section 727 of the current Bankruptcy Code. The 1898 Act was the first bankruptcy legislation to become a permanent law in the United States and remained in existence until superseded by the Bankruptcy Code, which became effective in 1979.

As part of the Chandler Amendments of 1938, Chapter XIII ("Wage Earners' Plans"), the predecessor to today's chapter 13, was added to the Bankruptcy Act of 1898. An individual wage earner filing under Chapter XIII could propose a plan to pay creditors out of future wages, salary or commissions. Chapter XIII, like the English system, generally withheld the debtor's discharge until completion of the repayment plan. Unlike the English system, the choice between Chapter XIII and the liquidation provisions of our 1898 Act (now chapter 7) was completely voluntary.

Although the bankruptcy system had offered an unconditional discharge since 1898, it was not until 1970 that Congress made the discharge self-executing for specific types of debts, particularly those incurred by means of an alleged false financial statement instead of an affirmative defense in subsequent litigation.

The suspended or conditional discharge remains the rule in England and was the rule in Germany until January 1, 1999. Until that date, discharge was not available without consent of 50% of creditors and 75% of the claims. Germ. KO §182. See Peltzer, German Insolvency Laws (1975). As of January 1, 1999, the German law eliminated the conditional discharge and adopted the U.S. law of unconditioned discharge. Germ. Insol.L. §§286, 290 (1999). The English rule is not the general rule in the United States under the Bankruptcy Code, which superseded the Bankruptcy Act in 1979 but continued its policy of unconditional discharge. A 1934 ruling of the United States Supreme Court offers a possible rationale for the American system of unconditional discharge:

> The power of the individual to earn a living for himself and those dependent upon him is in the nature of a personal liberty quite as much if not more than it is a property right. To preserve its free exercise is of the utmost importance, not only because it is a fundamental private necessity, but because it is a matter of great public concern. From the viewpoint of the wage-earner, there is little difference between not earning at all and earning wholly for a creditor. Pauperism may be the necessary result of either.

Local Loan Co. v. Hunt, 292 U.S. 234, 245 (1934). Although section 707(b), which was added to the Bankruptcy Code in 1984, is sometimes used to deny chapter 7 relief to debtors who are able to pay some or all of their debts, see Part III, *infra.*, our needs based bankruptcy system, for the most part, requires only current assets, and not future income, in exchange for a discharge of overwhelming debts.

PART III: BARRING CHAPTER 7 RELIEF IF CERTAIN PORTION OF DEBT CAN BE REPAID, E.G., THE CONSUMER CREDIT INDUSTRY'S VERSION OF "NEEDS-BASED BANKRUPTCY RELIEF."

Although some observers inaccurately blame the Bankruptcy Code of 1978 for increases in filings and abuse of the system, criticism of our bankruptcy laws far preceded the enactment of the new Bankruptcy Code. The unconditional discharge has always had its critics, even in the early 1900s, and representatives of the consumer credit industry importuned Congress or Congressional Commissions during the 1920s, 1930s, 1960s, 1970s, 1980s, and 1990s, to adopt, in effect, a conditional discharge system described in terms of a means test. See Charles Jordan Tabb, "The History of the Bankruptcy Laws of the United States," 3 ABI L. Rev. 5, 27(1995); Joint Hearings before Subcommittees of the House and Senate Judiciary Committees on S. 3863, 73rd Cong., 1st Sess., pp. 546, 641, 753 (1932)(proposing adoption of English system of conditional discharge).

In tracing the history of Congress' rejection of the consumer credit industry's needs-based bankruptcy proposals, it is useful to start with the rationale of the Congress that enacted the Bankruptcy Act of 1898. As stated in the 1897 House Report:

> This vast number constitutes an army of men crippled financially—most of them active, aggressive, honest men who have met with misfortune in the struggle of life, and who, if relieved from the burden of debt, would reenter the struggle with fresh hope and vigor and become active and useful members of society. . . . [T]he passage of a bankrupt law . . . will lift these terrible and hopeless burdens and restore to the business and commercial circles of the country the active and aggressive elements that have met with misfortune and are now practically disabled for the battle of life . . . when an honest man is hopelessly down financially, nothing is gained for the public by keeping him down, but, on the contrary, the public good will be promoted by having his assets distributed ratably as far as they will go among his creditors and letting him start anew. . . . The granting or withholding of it is dependent upon the honesty of the man, not upon the value of his estate.

H.R. Rep. No. 65, 55th Cong., 2d Sess. 30, 43 (1897).

Advocates of limiting bankruptcy relief for consumers had a friend in President Herbert Hoover, who recommended adoption of the English conditional discharge in his message to Congress in 1932:

> The discretion of the courts in granting or refusing discharge should be broadened, and they should be authorized to postpone discharges for a time and require bankrupts, during the period of suspension to make some satisfaction out of after-acquired property as a condition to the granting of a full discharge.

1 Collier, *supra*, at 14. While other of President Hoover's recommendations were enacted as part of the 1938 amendments, this conditional discharge recommendation was not.

Throughout the 1960s, the consumer credit industry engaged in efforts to gain enactment of its version of needs based bankruptcy, albeit unsuccessfully. See Statement of Frank R. Kennedy before the Subcommittee on Monopolies and Commercial Law of the House Committee on the Judiciary, "Antecedents of H.R. 4786" (March 25, 1982). See also Hearings on H.R. 1057 and H.R. 5771 before Subcommittee No. 4 of the House Committee on the Judiciary, 90th Cong., 1st Sess. (1967).

As in the 105th and 106th Congresses, prior consumer credit industry requests for a conditional discharge/means based system have been accompanied by claims of unprecedented numbers of bankruptcy filings, abuse of the system by unneedy debtors, and predictions of adverse changes in the consumer credit market if Congress fails to adopt the industry's request. *See, e.g.*, Statement of Robert B. Evans on behalf of the National Coalition for Bankruptcy Reform, before the Subcommittee on Courts of the Senate Committee on Judiciary (January 24, 1983).

"The number of bankruptcies in the United States has increased more than 1,000 percent annually in the last 20 years." Preamble to Senate Joint Resolution 88, a bill to establish a bankruptcy study commission in 1968.

> . . . [T]he crises that is now developing occurs to a large extent in the area of so-called consumer bankruptcies. In short, in our modern economy of credit cards and charge accounts, it is the wage earners and the heads of families who are coming more and more into the bankruptcy courts. Under the circumstances, it is essential that the bankruptcy system be overhauled and modernized.

Congressman Rogers, Chairman of Subcommittee No. 4, Congressional Record H6215 (June 30, 1970) on Senate Joint Resolution 88, to create a bankruptcy commission. Interestingly, there was no new bankruptcy law that could be blamed for such crises.

In 1970, Congress created a Commission on the Bankruptcy Laws of the United States to make recommendations in light of the social and economic changes that had occurred since 1898. The Commission filed its final report in 1973, including a draft bankruptcy statute. One of its major recommendations was to reject means testing proposals and to retain the unconditional discharge. The Report explained:

> [P]roposals have been made to Congress from time to time that a debtor able to obtain relief under Chapter XIII should be denied relief in straight bankruptcy. . . . The Commission has considered the arguments made for conditioning the availability of bankruptcy relief, including the discharge, on a showing by the debtor that he cannot obtain adequate relief from his condition of financial distress by proposing a plan for payment of his debts out of his future earnings. The Commission has concluded that forced participation by a debtor in a plan requiring contributions out of future income has so little prospect for success that it should not be adopted as a feature of the bankruptcy system.

Report of the Commission on the Bankruptcy Laws of the United States, H. Doc. No. 93–137, Pt. I, p. 159, 93d Cong., 1st Sess., Cong. (1973). In the House Report on the Bankruptcy Reform Act of 1978, the House of Representatives reiterated the 1973 Commission's position and rejected the notion of a mandatory chapter 13. Report of the House Committee on the Judiciary to Accompany H.R. 8200, H.R. Rep. No. 95–595, 95th Cong., 1st Sess. (1977).

The issue of means testing arose again only several years later, when critics opined that the 1978 Bankruptcy Code was responsible for a significant increase in the bankruptcy filing rate. The consumer credit industry embarked on a media and lobbying campaign and released industry funded studies to show that many chapter 7 debtors could pay their debts if they were obliged to do so. See Statement of Philip Shuchman, Rutgers School of Law, submitted for the American Bankruptcy Institute Panel Discussion on Consumer Finance and Other Substantive Amendments (January 31, 1984). Various pieces of legislation were introduced requiring that a determination of the debtor's earning potential be made before allowing chapter 7 relief or permitting creditors to bring objections to chapter 7 cases based on debtors' ability to pay. S. 2000, 97th Cong., 2d Sess.; *see also* H.R. 1800, H.R. 4786. In endorsing legislation that would permit consideration of future income, representatives of the credit industry testified that "about one person out of every four taking straight bankruptcy [chapter 7] walks away from debts he could pay, transferring $1.5 billion in affordable debts to other consumers in the form of higher prices and interest costs. Even worse for some lower income consumers, it means curtailed access to credit." Statement of Robert B. Evans, Senior Vice President and General Counsel, National Consumer Finance Association, on behalf of the National Coalition for Bankruptcy Reform, before the Subcommittee on Courts of the Senate Committee on Judiciary (January 24, 1983). Like today, the industry also reported a new phenomenon: surprise bankruptcy filings by borrowers with little or no previous history of delinquency and additional credit available, leading lenders to be doubtful that those filings were a last resort. *See, e.g.*, Statement of Raymond W. Klein representing the National Retail Merchants Association and the American Retail Federation before the Senate Judiciary Committee Subcommittee on Courts (January 24, 1983). During hearings before the Subcommittee on Monopolies and Commercial Law, House Committee on the Judiciary (March 25, 1982), both Professor Vern Countryman of Harvard Law School and Professor Frank Kennedy explained to the Subcommittee that the consumer credit industry's means testing proposals, and its justifications, were not new. Professor Countryman explained that "the consumer credit industry's current proposal is not inspired by the new Bankruptcy Code of 1978, although it may be inspired by the belief that the political climate is now more favorable to that proposal than it was in 1978. The industry has been pushing essentially the same proposal since 1964." Professor Countryman also reported separately that some of these means testing proposals had been attacked by witnesses as being "Un-American," see Vern Countryman, "Bankruptcy and the Individual Debtor—And a Modest Proposal to Return to the Seventeenth Century," 32 Cath. U.L. Rev. 809, 821 (1983), perhaps due to the fact that the unconditional discharge has sometimes been perceived as a safety valve integral to America's free market economy.

Although the consumer credit industry had garnered support in Congress for its means testing legislation in the early 1980s, means testing ultimately was rejected. The Senate report explained that "Crushing debt burdens and severe financial problems place enormous strains on borrowers and their families. Family life, personal emotional health, or work productivity often suffers. By enabling individuals who cannot meet their debts to start a new life, unburdened with debts they cannot pay, the bankruptcy laws allow troubled debtors to become productive members of their communities." S. Rep. No. 65, 98th Cong., 1st Sess. 2, 53 (1983).

The amendments that resulted in 1984 were quite favorable to the consumer credit industry, even without means testing. One such amendment was section 707(b), which permits the court to dismiss a chapter 7 case if obtaining chapter 7 relief would be a substantial abuse of the provisions of chapter 7. Although reasonable people may differ on the wisdom of section 707(b) and its intended function, many courts and United States trustees use the provision to dismiss chapter 7 cases for the ability to pay debts or for specific bad acts.

Congress again made a variety of amendments to the Bankruptcy Code in the Bankruptcy Reform Act of 1994, and again retained unfettered access to chapter 7 for the honest individual. However, the 1994 Act created another Commission to study the bankruptcy system. The Commission submitted a report to Congress in October, 1997. Seven out of nine members of this Commission were unwilling to recommend that Congress consider a means testing system, but two members submitted a statement recommending that Congress consider means testing proposals. *See* Report of the National Bankruptcy Review Commission (October 20, 1997).

A historical perspective on the consumer credit industry's needs based bankruptcy proposal ends with the current legislative endeavor, the Bankruptcy Reform Act of 1999 (H.R. 833). H.R. 833 proposes that chapter 7 relief be denied to any individual or family able to pay a portion of their debts according to a set formula set forth in section 102 of the bill. The means testing formula applies to all individual debtors who seek recourse in chapter 7, regardless of their income level. Although my historical perspective has focused primarily on needs based bankruptcy and means testing as they affect the unconditional discharge, the means testing provision is only one of hundreds of significant amendments in H.R. 833, all of which should be considered with care and many of which should be summarily discarded.

CONCLUSION.

Throughout the past century, Congress has decidedly disavowed any inclination to mitigate the unconditional discharge for honest debtors. It may appear to Congress that there is now widespread support for the consumer credit industry proposal to reject the unconditional discharge in favor of means testing. However, most people familiar with the workings of the current bankruptcy system probably do not believe that the credit industry means testing proposal is necessary or cost-justified, even if they generally support bankruptcy reform. The reasons supporting past rejections of means testing throughout the past Century—maintenance of employment incentives, family stability, logistical difficulties in predicting future income and expenses, consistency with our market economy, efficiency, and basic humanitarianism—still exist today.

LAWRENCE P. KING

Charles Seligson Professor of Law, New York University School of Law; counsel, Wachtell, Lipton, Rosen & Katz, New York City.

B.SS., City College of New York (1950); LL.B., New York University (1953); LL.M., University of Michigan (1957).

Member, Advisory Committee on Bankruptcy Rules, Judicial Conference of the United States (1983–1992); Reporter to the Advisory Committee (1979–1983); Associate Reporter to the Advisory Committee (1968–1976); Consultant, Commission on the Bankruptcy Laws of the United States (1972–1973); Senior Advisor, National Bankruptcy Review Commission (1996–1997).

Member: National Bankruptcy Conference;
American College of Bankruptcy;
American Law Institute;
American Bar Association, Committee on Commercial Bankruptcy;
New York Sate Bar Association;
Association of the Bar of the City of New York.

Editor-in-Chief, *Collier on Bankruptcy* (15th ed.), (15th ed. rev.);

Co-Editor-in-Chief, *Collier Bankruptcy Practice Guide*;

Co-author, King & Cook, *Creditors' Rights, Debtors' Protection and Bankruptcy* (3d ed. 1996);

Co-author, Duesenberg & King, *Sales and Bulk Transfers Under the Uniform Commercial Code.*

I have not received any federal grant, contract or subcontract during the current and preceding two fiscal years.

Mr. CHABOT. Thank you very much, Professor.
Mr. Mabey?

STATEMENT OF RALPH R. MABEY, LeBOEUF, LAMB, GREENE AND MacRAE, SALT LAKE CITY, UT

Mr. MABEY. Thank you.

I would like to just touch on what Professor King said with respect to the decline of the stigma of bankruptcy. I think it is a very interesting question, and indeed, I recall that the Solicitor General of the United States in 1930 made similar arguments that the stigma of bankruptcy was dying.

It has had a very long and slow death, this stigma, it would appear, and the facts, I think, today demonstrate that it is not dead.

Today's debtors in bankruptcy have at least as much debt as compared to their income as they did in 1981. In 1991, debtors who filed bankruptcy generally earned less than those who filed bankruptcy in 1981.

In other words, in general, in 1991, the real median family income of those who filed bankruptcy was only $18,000. In 1981, it was over $22,000.

These facts, I think taken together, suggest that the stigma of bankruptcy or its lack does not explain the skyrocketing rise in bankruptcies. People try to stay out of bankruptcy just as long until they are just as bad off today as they did, say, 10 years ago.

So I ask, then, why in our national prosperity are so many consumers bad off when you look at their balance sheets? An overriding reason, I believe, is America's staggering consumer debt, which approaches $800 billion. I submit that it is the stigma of borrowing on our credit cards, for instance, that is dead as a doornail, and not the stigma of bankruptcy.

Just look at the numbers, and I am reliant on Moss and Johnson's Harvard Business School working paper. Between 1983 and 1992, those earning less than $10,000 increased their consumer debt 49 percent. Those earning only between 10- and $20,000 increased their consumer debt 82 percent. All of those earning less than $50,00 taken together increased their consumer debt 56 percent.

In a nutshell, poor Americans are borrowing much more on their credit cards, and they are borrowing it much faster.

These people, as the data I earlier cited show, are the ones who are filing bankruptcy, and it follows. They have less ability to avoid the bumps in the road.

It has followed, then, in America as night follows day that as poorer Americans have increased their consumer debt, our bankruptcies have skyrocketed. Why has credit card debt exploded among poorer Americans? Among other reasons, because of the effective elimination of the usury laws under the Marquette decision, which according to Diane Ellis of the FDIC fundamentally altered the market for credit card loans in a way that significantly expanded the availability of credit and increased the average risk profile of borrowers.

The result was a substantial expansion of credit card availability, and a reduction in the average credit quality and an increase in bankruptcies.

I know that consumption is a powerful engine that drives our economy, but I do not believe that high levels of consumer debt are healthy for Americans, especially when new credit card borrowing is sold increasingly to those who can least afford it.

In conclusion, I say that it is not healthy for our body politic or for our souls in the long run to have high consumer debt, and it is not in the interest of our individual well-being and our prosperity as a Nation.

Accordingly, I think that we must be very careful what we do with the bankruptcy laws. If we tighten them, Mr. Chairman, by, for instance, making more credit card debt nondischargeable, as H.R. 883 does, we will make credit card lending more profitable, resulting in more consumer debt and more problems for Americans.

When we tightened the laws in 1984, that was the result. I ask this committee to act cautiously with respect to the bankruptcy laws so as not to increase profitability for credit card lending to poorer Americans such as to increase credit card debt which I submit is the real problem that this country faces.

Thank you.

[The prepared statement of Mr. Mabey follows:]

PREPARED STATEMENT OF RALPH R. MABEY, LEBOEUF, LAMB, GREENE AND MACRAE, SALT LAKE CITY, UT

I. HISTORICAL SETTING: WHY DO WE SOMETIMES FORGIVE OUR DEBTORS?

"If I can once get square, I will never contract another debt."
—Robert Morris, Debtor and Patriot.

When the neighbors file bankruptcy, should we deliver sympathy and a casserole—or warn our kids against playing with their kids to avoid the taint of shame and irresponsibility?

Should the government allow creditors to hold the debtor up to public ridicule for three days and then divide the debtor's body into pieces in satisfaction of their debts—as in Rome?[1]

Or command forgiveness of debt and grant a fresh start to debtors after every seventh year, as required in the Bible at Deuteronomy Chapter 15, which further admonishes: "See that you do not harbor iniquitous thoughts when you find that the seventh year, the year of remission, is near and look askance at your needy countryman and give him nothing. If you do, he will appeal to the Lord against you, and you will be found guilty of sin."[2]

In answer to these questions, by fits and starts, with much impassioned soul searching, debate and recrimination, the United States has for two centuries moved inexorably toward greater relief and respect for individual debtors.

Before our independence, we were a country of debtors. A large number of early European settlers came here under indenture.[3]

One of the precipitating factors of the Declaration of Independence was the British invalidation of debtor relief laws in Massachusetts and Virginia. In justifying its actions, the British Board of Trade noted that nine out of every 10 creditors resided in Great Britain—the Americans were the debtors.[4] Following the War of Independence, on August 31, 1786, debtor farmers marched on Boston during Shays'

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[1] *See* Buchbinder, *A Short History of Bankruptcy*, NORTON BANKR. L. ADVISER Nov. 1988 at 9. Professor Countryman has pointed out another grim yet fascinating collection technique employed by the ancient Romans: seizing a deceased debtor's corpse to extract payment from his or her heirs. *See* Vern Countryman, *Bankruptcy and the Individual Debtor—And a Modest Proposal to Return to the Seventeenth Century*, 32 CATH. U.L. REV. 809, 810 (Summer 1983).

[2] *Book of Deuteronomy* 15:9.

[3] Countryman, *Bankruptcy and the Individual Debtor—And a Modest Proposal to Return to the Seventeenth Century*, 32 CATH. U.L. REV. at 812.

[4] *See* Hacker, *The Shaping of the American Tradition*, at 174 (1947)

Rebellion, mobbing the court to prevent it from imprisoning fellow farmers for their debts.[5]

As he argued before the Supreme Court in *Ogden* v. *Saunders*, and later in Congress for the Bankruptcy Act of 1841, the Massachusetts statesman Daniel Webster remarked of the post-Revolutionary crisis:

> "The relation between debtor and creditors, always delicate, and always dangerous, whenever it divides society, and draws out the respective parties into different ranks and classes, was in such condition in the years 1787, 1788, and 1789 as to threaten the overthrow of all government; and a revolution was menaced, much more critical and alarming than that through which the country had recently passed."[6]

As a result of the gravity of these issues around the time of the Constitutional Convention, in 1789, the U.S. Constitution was adopted with explicit bankruptcy authority granted to Congress.

Soon thereafter, the crash of 1792 and the panic of 1797 resulted in the imprisonment under state law of thousands of debtors.[7] In fact, debtors' prison persisted under state law until the 1830s[8]; during some periods, there were in Pennsylvania, New York, Massachusetts and Maryland three to five times more debtors in prison than criminals.[9]

The Bankruptcy Act of 1800

Congress responded with the Bankruptcy Act of 1800, which was similar to the English law in effect at the time of independence.[10] The 1800 Act was repealed in 1803.

One of the lamentable stories from this period is that of Robert Morris, who had the honor to sign the Declaration of Independence, the Articles of Confederacy and the U.S. Constitution. After master-minding the financing of the early American government and the Yorktown campaign, he experienced considerable misfortune speculating on land out West, incurring debts that landed him in Philadelphia's Prune Street Jail from 1798 to 1801.[11] Morris was eventually relieved by the Bankruptcy Act of 1800.[12]

The Bankruptcy Act of 1841

Following the devastating panic of 1837, the trail-blazing, and controversial, Bankruptcy Act of 1841 became law; it was repealed 18 months later. The 1841 Act was the first enactment in Anglo-American law to provide for voluntary bankruptcy and to eliminate the restriction of bankruptcy eligibility to merchants. In other words, for the first time, the *debtor* could file bankruptcy—until the 1841 Act only creditors could put a debtor into bankruptcy, action which they took to make it easier to collect their debts. And for the first time ordinary citizens, consumers as we say today, could file bankruptcy.[13] Although the Supreme Court did not address the

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[5] *See* Bernard R. Trujillo, *The Wisconsin Exemption Clause Debate of 1846: An Historical Perspective on the Regulation of Debt*, 1998 WIS. L. REV. 747, 754 (1998); David P. Szatmary, *Shays' Rebellion: The Making of an Agrarian Insurrection (1980); Massachusetts Gazette* (October 20, 1786).

[6] 6 Daniel Webster, *Works* 34 (1851); *see also Ogden* v. *Saunders*, 12 Wheat. 213, 247 (1827).

[7] Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 5, 15 (Spring 1995).

[8] *Id.*

[9] *See* Buchbinder, *A Short History of Bankruptcy,* NORTON BANKR. L. ADVISER Nov. 1988 at 11.

[10] The Statute of 5 George II, c. 30, enacted in 1732, was the bankruptcy law in effect at the time the United States became independent. The 1732 act included these features: only traders (merchants) were eligible as debtors; bankruptcy was involuntary; discharge required creditor consent and approval of the commissioners; the debtor could receive an allowance; the debtor also was allowed to retain certain exempt property (e.g. tools of the trade and clothing); and a fraudulent debtor suffered "as a felon, without benefit of clergy." *See* Tabb, *The Historical Evolution of the Bankruptcy Discharge*, 65 AM. BANKR. L.J., at 341–42. The Act of 1800 contained all of these features, except that fraudulent debtors were imprisoned, not executed.

[11] *See* C. Warren, *Bankruptcy in United States History* at 13 (1935); Encyclopedia Americana, v.19, at 473–74.

[12] Tabb, *The Historical Evolution of the Bankruptcy Discharge*, 65 Am. Bankr. L.J. at 348.

[13] While the 1841 Act made it easier for a debtor to seek a discharge (both substantively and procedurally), it contained more exceptions to discharge than the 1800 Act, including fraud, concealment of property, making a preferential payment, wilful failure to comply with court orders, wilful failure to comply with the Act, admitting a fictitious debt, applying trust funds to the debtor's own use, and, in the case of merchants, not keeping adequate books and records of account. Tabb, *The Historical Evolution of the Bankruptcy Discharge*, 65 AM. BANKR. L.J. at 351–52.

1841 Act before it was repealed in 1843 due to political resistance, its constitutionality was upheld at the circuit level, bringing voluntary bankruptcy by non-merchants within the ambit of Congress's bankruptcy power.[14]

During the brief period governed by the 1841 Act, 33,739 debtors were adjudicated bankrupt, of whom only 765 were denied a discharge.[15] Seventy-seven debtors, from 25 Illinois counties, had the honor of being represented by Abraham Lincoln or his firm, Logan & Lincoln, which handled more bankruptcies than any other firm in Springfield, Illinois.[16]

The Bankruptcy Act of 1867

The panic of 1857 and the cataclysm of the Civil War brought enactment of the Bankruptcy Act of 1867, repealed in 1878.[17] The Act of 1867 allowed the debtor to retain increased exempt property under state or federal exemptions and required a 50% distribution to creditors and creditor consent as preconditions to a discharge (the 50% requirement was later reduced by Congress to 30%; the creditor-consent requirement would later be discarded entirely in the 1898 Act).[18] However, the 1867 Act contained so many grounds for denying discharge that fewer than 1/3 of the debtors filing under the Act ever received a discharge.[19]

These three laws were born and died amid controversy. But taken together they contained dramatic American innovations, favorable to ordinary American debtors: Individual debtors were given voluntary access to bankruptcy relief, to broader state exemptions, and to the discharge of their debts with less creditor approval.[20]

The Bankruptcy Act of 1898

The Bankruptcy Act of 1898, largely with us today in concept although superseded by the 1978 Bankruptcy Reform Act and subsequent amendments, consolidated and improved many of these innovations for the benefit of debtors while also enacting many credit industry initiatives governing the distribution of assets and payment of creditors.[21]

In 1934 the United States Supreme Court encapsulated the American view toward the discharge of individual debtors through bankruptcy as follows:

> One of the primary purposes of the Bankruptcy Act is to "relieve the honest debtor from the weight of oppressive indebtedness and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes." (Citation omitted.) This purpose of the act has been again and again emphasized by the courts as being of public as well as private interest, in that it gives to the honest but unfortunate debtor who surrenders for distribution the property which he owns at the time of bankruptcy, a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of pre-existing debt. (Citations omitted). . . .
>
> When a person assigns future wages, he, in effect, pledges his future earning power. The power of the individual to earn a living for himself and those dependent upon him is in the nature of a personal liberty quite as much if not more than it is a property right. To preserve its free exercise is of the utmost importance, not only because it is a fundamental private necessity, but because it is a matter of great public concern. From the viewpoint of the wage-earner there is little difference between not earning at all and earning wholly for a creditor. Pauperism may be the necessary result of either. The amount of the indebtedness, or the proportion of wages assigned, may here be small, but the

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[14] *In re Klein*, appended in notes at 42 U.S. (How.) 277 (1843); Tabb, *The Historical Evolution of the Bankruptcy Discharge*, 65 Am. Bankr. L.J. at 351–52.

[15] *Id.*, at 353.

[16] *See* Harry E. Pratt, *Lincoln and the Bankruptcy Law*,—JOURNAL OF THE NATIONAL ASSOCIATION OF REFEREES IN BANKRUPTCY 98 (April 1943).

[17] Also in 1867, Congress made peonage a crime. *See* Countryman, *Bankruptcy and the Individual Debtor—And a Modest Proposal to Return to the Seventeenth Century*, 32 CATH. U.L. REV. at 816; citing 14 Stat. 546 (1867) (codified as 18 U.S.C. § 1581 (1976 & Supp. V 1981) and 42 U.S.C. § 1994 (1976 & Supp. IV 1980). In upholding the criminal statute, the Supreme Court observed that peonage is "a status or condition of compulsory service based upon the indebtedness of a peon to the master. The basal fact is indebtedness . . . [whether] the debtor voluntarily contracts to enter the service of his creditor [or is bound] by some provision of law . . . [P]eonage, however created, is compulsory service, involuntary servitude." *Clyatt* v. *United States*, 197 U.S. 207, 215 (1905).

[18] *See* Tabb, *The Historical Evolution of the Bankruptcy Discharge*, 65 Am. Bankr. L.J. at 357.

[19] *Id.*

[20] Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 14–21.

[21] Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 5, 24–26 (Spring 1995).

principle, once established, will equally apply where both are very great. The new opportunity in life and the clear field for future effort, which it is the purpose of the Bankruptcy Act to afford the emancipated debtor, would be of little value to the wage-earner if he were obliged to face the necessity of devoting the whole or a considerable portion of his earnings for an indefinite time in the future to the payment of indebtedness incurred prior to his bankruptcy. . . .[22]

Conclusions

With this historical context in mind, I suggest the following reasons why, for a century and more, United States law favors a fresh start for honest debtors—with relatively few strings attached:

(1) We have a tradition of an independent, creative, entrepreneurial, and risk-taking citizenry.[23]

(2) We have long-since abandoned Blackstone's view that "the law holds it to be an unjustifiable practice, for any person but a trader to encumber himself with debts of any considerable value".[24] As early as the latter part of the 1920's, it has been estimated that installment sales as a percentage of total sales reached 38% for furniture stores, 50% for household appliance stores, and between 60 and 65% for new and used automobiles.[25] Today, household debt (including house and car loans) approaches $4 trillion, nearly a fourth of which is pure consumer debt.[26] Consumer debt is an exceedingly powerful engine driving our economy. As early as 1931, the existence and increase in consumer debt was linked to the need for bankruptcy and a fresh start.[27]

3. We have a relatively free market economy which imposes relatively great risks (and opportunities) on our citizens and provides relatively meager safety nets. The fresh start is one of those safety nets.

II. THE IMPACT OF THE 1978 BANKRUPTCY REFORM ACT: DID IT LEAD TO INCREASED FILINGS? IF NOT, WHAT HAS?

Consumer Debt Precipitates Consumer Bankruptcies

Generally speaking, as one might suppose, the level of consumer debt influences the level of consumer bankruptcies. A recent analysis [28] of the incidence of consumer bankruptcies strongly indicates that, from approximately 1920 to 1985, the gradual rise in consumer bankruptcy filings was probably caused by the rise in consumer debt (with additional bankruptcy hills and valleys explained by episodes of pronounced recession and prosperity). In other words, for about 65 years, from 1920 to about 1985, for every billion dollars of real consumer debt outstanding (in 1967 dollars) the annual number of bankruptcy filings was usually not far from the long-term average of 1,735.[29] I believe, therefore, that until 1985 the rise in consumer bankruptcy filings is best explained by the rise in consumer debt—in the main,

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[22] *Local Loan Co.* v. *Hunt*, 292 U.S. 234, 78 L.Ed. 1230, 54 S.Ct. 695 (1934).

[23] *See* Karen Gross, *Failure and Forgiveness: Rebalancing the Bankruptcy System*, 94–97 (1997) (noting the importance of forgiveness and renewal through discharge in a credit economy: "Because taking risks is precisely what we want people to do, we need a mechanism for dealing with the inevitable failures that are part of the process . . . [W]e want debtors to continue what they were doing but with a different outcome, that is, success as distinguished from failure."); *see also* Margaret Howard, *A Theory of Discharge in Consumer Bankruptcy*, 48 OHIO ST. L. J. 1047, 1048 (1987) ("discharge should be broadly available in order to restore the debtor to participation in the open credit economy").

[24] *See* Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 5, 9 (Spring 1995).

[25] David Moss and Gibbs Johnson, a Harvard Business School working paper entitled *The Rise of Consumer Bankruptcy: Evolution, Revolution, or Both?*, at 11, fn 19 (1998).

[26] *Id.*, Appendix A.

[27] *Id.*, at 12.

[28] The study by David Moss and Gibbs Johnson, a Harvard Business School working paper entitled *The Rise of Consumer Bankruptcy: Evolution, Revolution, or Both?* (1998), provides an interesting overview of causal factors to which the currently heightened levels of consumer filings may be attributable. Moss and Gibbs do not dismiss outright the conventional explanations of increasing ease in filing and a decreasing stigma attached with bankruptcy, but do point out the paucity of empirical evidence to support these hypotheses (the authors also show that the ease-of-filing and decreasing-stigma theories are not new, but have been a consistent theme throughout this century). Moss and Johnson offer an alternative explanation based on the increasing amounts of consumer debt among poorer Americans since the mid-1980's.

[29] Using a measure they call the "consumer bankruptcy multiplier" (the number of consumer bankruptcy filings per one billion dollars of real consumer debt), Moss and Johnson found that this ratio remained fairly constant (an average of 1,735 filings per billion dollars of debt) from 1920 to 1985 (with pronounced deviations occurring during the Great Depression and during World War II), but that the multiplier has increased dramatically since 1985. Moss and Johnson, *The Rise of Consumer Bankruptcy: Evolution, Revolution, or Both?*, at 5.

when consumer debt rose, consumer bankruptcy filings rose. Since 1985, however, this has changed—consumer filings have not simply kept pace with the increase in real consumer debt, but instead, consumer filings per billion dollars of debt have soared.

With the enactment of the 1978 Bankruptcy Reform Act, bankruptcy filings rose faster than consumer debt for a couple of years, but bankruptcy filings, as a function of consumer debt, declined in 1983 and 1984. Then, notwithstanding the pro-creditor bankruptcy reforms adopted in 1984, bankruptcy filings as a function of total consumer debt again surged upward.

The 1978 Act

What explains that, following adoption of the 1978 Bankruptcy Reform Act, bankruptcy filings per billion dollars of consumer debt shot up for a couple of years, then declined for a couple of years, only to shoot up again after the stricter 1984 reform act was adopted? It does not make sense to me to lay these trends at the feet of the law; if the law caused the bankruptcies, bankruptcy filings, in relation to consumer debt, would not have declined in 1983 and 1984, and then shot up again after stricter laws were passed in 1984. The law's operation does not explain these variations. The explanations are elsewhere. I am inclined to put substantial credence in the following analysis of Moss and Johnson:

> There are several other reasons why one might be skeptical of those who blame the 1978 reforms for the subsequent explosion of consumer filings. First, the changes in the law were not actually all that dramatic. As Vukowich has noted, 'These slight changes [involving discharge provisions under Chapter 13 as well as a minimum federal exemption] hardly account for the large increase in bankruptcy filings or for all the 'abuses' alleged to occur under the new law.' Second, the Bankruptcy Reform Act was not the only contextual change that might have affected filing rates in the late 1970s and early 1980s. Advertising by bankruptcy lawyers, for example, appears to have increased substantially after the Supreme Court ruled in 1977 that lawyer advertising represents commercial speech and is thus protected under the First Amendment. The early 1980s were also a period of considerable macroeconomic distress. The unemployment rate had reached its trough level of 5.8 percent in 1979 and then commenced a steep ascent to a peak of 9.7 percent in 1982. In fact, the rise in the consumer bankruptcy multiplier from 1979 to 1982 coincides rather neatly with the rise in the national unemployment rate. Third, and perhaps most damning for those who attribute the rapid growth of consumer filings to the pro-debtor provisions of the 1978 Act, is the fact that the multiplier did not slow down or reverse course when Congress enacted a set of pro-creditor bankruptcy reforms in 1984. On the contrary, this was precisely the moment when the multiplier commenced its most rapid, sustained, and unprecedented ascent. It may be that consumer debtors are simply not as sensitive to changes in the bankruptcy law as some analysts apparently believe."[30]

The Bankruptcy Skyrocket Was Launched in About 1985—Not by New Laws, But by Dramatic Increases in Consumer Lending to Poorer Americans

The radical increase in consumer filings began after the enactment of the stricter 1984 bankruptcy laws.[31] From 1985, bankruptcy filings, as a function of outstanding

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[30] Moss and Johnson, *The Rise of Consumer Bankruptcy: Evolution, Revolution, or Both?*, at 29–30.

[31] The 1984 amendments were creditor friendly, based in considerable part on the consumer lender industry's proposals. Moss and Johnson argue that, by nominally favoring creditors, these amendments triggered a greater shift of consumer credit down the income spectrum, quoting Business Week as to the industry's renewed ability to reach higher risk consumers: "Lenders say they will make more unsecured loans from now on, trying to lure back the generally younger and lower-income borrowers recently turned away." Moss and Johnson at 43, citing "Consumer Lenders Love the New Bankruptcy Law," BUSINESS WEEK, August 13, 1984, at 108. Moss and Johnson note another study that indicates that consumer lenders are influenced by fluctuations in the stringency in bankruptcy and exemption laws. Moss and Johnson, *The Rise of Consumer Bankruptcy: Evolution, Revolution, or Both?*, at 44, citing Reint Gropp, John Karl Scholz and Michelle J. White, *Personal Bankruptcy and Credit Supply and Demand*, 112 QUARTERLY JNL. OF ECONOMICS at 245 (Feb. 1997). This study found that more lenient laws tend to result in greater numbers of credit applicants being denied, thereby shifting debt to less risky, more solvent borrowers. Conversely, lower exemption levels lead to easier credit. Moss and Johnson, *The Rise of Consumer Bankruptcy: Evolution, Revolution, or Both?*, at 44. Moss and Johnson conclude that if rational lenders are more responsive than consumer debtors to changes in bankruptcy and exemption laws, tightening such laws may actually result in higher default or bankruptcy rates by shifting more consumer debt to less credit-worthy borrowers. *Id.*

consumer debt, have shot to levels unknown even in the Great Depression.[32] In 1935, 3,468 bankruptcies were filed for every billion dollars of consumer debt outstanding (in 1967 dollars). In 1997, 5,380 consumer bankruptcies were filed for every billion dollars of consumer debt![33]

I believe the bankruptcy "crisis" is found not in the absolute number of consumer filings, but in the unprecedented number of bankruptcies per billion dollars of consumer debt, which has risen every year since 1985.

I believe a credible explanation for this crisis is found in the Federal Reserve's data on the distribution of consumer debt: between 1983 and 1992 poorer Americans increased their consumer debt-to-income ratios at a dramatic and unprecedented rate that parallels the surge upward in consumer bankruptcy filings. *Whereas the bottom 45% of American households, as measured by income, carried only 42% of all consumer debt in 1983, by 1992, the bottom 36% of American households, as measured by income, carried 56% of all consumer debt*[34]. The dramatic increase in consumer debt for the average low income household is illustrated as follows:

[32] Moss and Johnson, *The Rise of Consumer Bankruptcy: Evolution, Revolution, or Both?*, at 21, 25.

[33] *Id.*

[34] "In constant dollar terms (1992 dollars), households with incomes under $50,000 carried $256.6 billion of consumer debt in 1983 (or $3,981 per household) and $437.5 billion in 1992 (or $6,239 per household). Recent analyses of the Federal Reserve's 1995 Survey of Consumer Finances, moreover, confirm that these trends did not end in 1992. Over at least the next three years, lower-income households continued to take on consumer debt at a faster pace than upper-income households." (Moss & Johnson, *The Rise of Consumer Bankruptcy: Evolution, Revolution, or Both?*, p.48)

Dollars per Household (in 1992 dollars)	1983			1989			1992		
	Consumer Debt (dollars)	Household Debt (dollars)	Disposable Income (dollars)	Consumer Debt (dollars)	Household Debt (dollars)	Disposable Income (dollars)	Consumer Debt (dollars)	Household Debt (dollars)	Disposable Income (dollars)
Income (1992 dollars)									
Less than 10,000	1,580	3,834	7,042	1,742	3,737	6,194	2,362	4,990	6,595
10,000–19,999	2,780	7,112	16,351	3,448	7,271	15,276	5,074	9,572	16,038
20,000–29,999	4,962	14,107	27,267	6,330	16,880	26,333	7,779	20,089	26,868
30,000–49,999	5,781	24,485	42,813	11,245	32,922	40,344	9,485	37,038	42,084
Less than 50,000, combined	3,981	13,477	25,253	5,981	16,110	22,981	6,239	18,461	23,422

All figures in 1992 dollars. Sources: Moss and Johnson, *The Rise of Consumer Bankruptcy: Evolution, Revolution, or Both?*, Appendix A; Glenn B. Carter, Arthur B. Kennickell, and Charles A. Luckett, "Household Sector Borrowing and Burden of Debt," *Federal Reserve Bulletin*, Vol. 81, No. 4 (April 1995), tables 1, 4, and 6, at 326, 330, 332, *Economic Report of the President* (Washington, GPO 1998), tables B–31, B–62, and B–77, at 318, 352, 350, 372.

Why has there been such a startling increase in consumer borrowing by poorer Americans? A number of reasons have been suggested. Interest rate deregulation[35] and the general lowering of prime interest rates[36] allowed credit card issuers to give credit cards (by the millions) to low-income borrowers who constituted sub-prime risks. Lenders were free to hedge their lending risks by charging interest rates without fear of usury laws. All of us know, at least anecdotally, that consumer credit opportunities have been aggressively, and successfully, sold to low-income America.

Why, since 1985, when low-income Americans began to take on so much additional consumer debt relative to their capacities to pay, have bankruptcies risen? Because these Americans are, taken together, less able to pay their debts and therefore, more likely in need of bankruptcy protection.[37]

III. WHAT OF THE DEATH OF STIGMA?

In the recent debates surrounding the proposed amendments to the Bankruptcy Code, much has been said about bankruptcy's "loss of stigma." In the words of Alan Greenspan, "personal bankruptcies are soaring because Americans have lost their sense of shame."[38]

Mr. Greenspan's view is more than 60 years old. For example, in 1930 Thomas D. Thacher, then Solicitor General of the United States, complained that too many workers were "accustomed to pay their debts by postal card" (referring to the form of notice mailed upon a bankruptcy filing), and attributed this to the "disregard of business integrity" encouraged by the bankruptcy laws of the time.[39] And a 1933 white paper released by the Department of Commerce in tandem with the Yale Law

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[35] In 1978 the Supreme Court ruled that state usury limits on credit card rates would apply in the state where the credit card lender was based, not where the card holder resided, creating incentives for lenders to relocate to states with high usury limits and for state legislatures in turn to relax usury legislation. *See Marquette Nat'l Bank* v. *First of Omaha Serv. Corp.*, 439 U.S. 299 (1978). *See also* Diane Ellis, Federal Deposit Insurance Corporation, Division of Insurance, *The Effect of Consumer Interest Rate Deregulation on Credit Card Volumes, Charge-Offs, and the Personal Bankruptcy Rate*, BANK TRENDS No. 98–05 (March 1998) (arguing that *Marquette* "fundamentally altered the market for credit card loans in a way that significantly expanded the availability of credit and increased the average risk profile of borrowers. . . . The result was a substantial expansion in credit card availability, a reduction in average credit quality, and a secular increase in personal bankruptcies."). Moss and Johnson argue that the prior stability of state usury laws may have stabilized the incidence of consumer bankruptcy by effectively making it uneconomical for credit card companies to extend credit to lower income borrowers, preventing consumer credit from concentrating among higher-risk debtors. Moss and Johnson, *The Rise of Consumer Bankruptcy: Evolution, Revolution, or Both?*, at 33–34.

[36] Moss and Johnson observe that in 1980, the typical credit card rate reported by the Federal Reserve was approximately 17.3%, while the one-year Treasury Bill rate was 10.75%. By 1985, the typical credit card rate had risen to 18.7%, while the one-year Treasury Bill rate had fallen to 7.76%. Hence, the cost of credit for the credit card companies was falling, while the price they charged card holders was rising. Moss and Johnson, *The Rise of Consumer Bankruptcy: Evolution, Revolution, or Both?*, at 37.

[37] Another factor considered by Johnson and Moss is the increase in home-equity lending. While factoring in secured household debt does not change the "consumer bankruptcy multiplier," the authors suggest that the emergence of home-equity lending as a lower-cost alternative for borrowers who are sufficiently confident that they can repay that they do not fear losing their homes may have pulled lower-risk borrowers away from the unsecured consumer debt market, requiring lenders to move still farther down the debtor ladder. Moss and Johnson, *The Rise of Consumer Bankruptcy: Evolution, Revolution, or Both?*, at 40. This is relevant, the authors argue, because the bankruptcy discharge is of greater benefit to a debtor with a higher proportion of unsecured consumer debt, influencing the consumer's decision whether to file. Moss and Johnson point to the study of consumer bankruptcy by Professors Sullivan, Warren and Westbrook, which found that bankrupts in their 1981 sample had similar levels of mortgage debt as non-bankrupts, but that their unsecured consumer debt level was much higher. *Id.*, at 41–42, citing Teresa A. Sullivan, Elizabeth Warren, and Jay Lawrence Westbrook, *As We Forgive Our Debtors*, at 69. Interestingly, the follow up study by Sullivan, Warren and Westbrook ten years later revealed that, between 1981 and 1991, the median bankrupt in their samples experienced a 23% rise (in real terms) in unsecured debt and a 24% decrease (in real terms) in secured debt. Moss and Johnson at 42, citing Sullivan, Warren and Westbrook, *Consumer Debtors Ten Years Later: A Financial Comparison of Consumer Bankrupts 1981–1991*, 68 AM. BANK. L. J. at 128 (Spring 1994). Moss and Johnson infer from this that the rise in consumer bankruptcies may be attributable in part to greater concentrations of unsecured consumer debt at lower income strata.

[38] Moss and Johnson, *The Rise of Consumer Bankruptcy: Evolution, Revolution, or Both?*, at 1, citing Julie Kosterlitz, "Over the Edge," *National Journal*, Vol. 29, No. 18, at 871 (May 3, 1997).

[39] Moss and Johnson, *The Rise of Consumer Bankruptcy: Evolution, Revolution, or Both?*, at 2, citing Thomas D. Thacher, "Administration of the Bankruptcy Act," *Report of the Fifty-Third Annual Meeting of the American Bar Association*, at 255 (1930).

School said that many "consumers appearing in the bankruptcy courts . . . consider the receipt of a legal discharge of their debts as a creditable achievement. Freedom from debt without being held accountable for his past actions encourages the unconcerned debtor to resume his wasteful and extravagant habits." The report noted that there was no penalty for the discharge "other than the stigma of a bankrupt . . . [and that in] . . . recent years the significance of this penalty has been gradually diminishing.[40]

The stigma of bankruptcy seems to be suffering a decades-long death allowing for repeated eulogies over its surprisingly warm body.

In Fact, Studies Show That Americans Today Wait to File Bankruptcy Until They Are At Least As Bad Off as Their Predecessors Were When They Filed Bankruptcy

I believe the following facts suggest that The Bankruptcy Stigma still makes people today wait until they are at least as bad off as their predecessors were before they file bankruptcy:

1. Today's debtors who file bankruptcy have at least as much debt as compared to their income as did debtors who filed bankruptcy in 1981.[41]
2. 1991's debtors who filed bankruptcy generally earned less than those who filed bankruptcy in 1981.[42]
3. Out of a sample of 1,000 chapter 7 debtors recently analyzed, approximately 96 percent would not be able to pay even 20 percent of their unsecured debts out of post-bankruptcy income over five years.[43]

The Stigma of Consumer Debt, Not Bankruptcy, Is Dead

I believe the operative stigma which has died among Americans is the stigma of consumer debt: We (both lenders and borrowers) embrace consumer debt much more than we should and it often leads to our financial undoing. Consumers often borrow sums "beyond their means" (although, faced with catastrophic illnesses or sudden unemployment, they sometimes have little choice). Lenders knowingly extend credit to high-risk borrowers (although these borrowers sometimes use this credit to turn their fortunes around).

How Do We Adjust to The Death of the Stigma of Debt?

Not by tightening the bankruptcy laws without very careful thought. If we tighten the bankruptcy laws by, for instance, making more credit card debt non-dischargeable as H.R. 833 would, then we make credit card lending more profitable—probably resulting in more credit card lending, and more consumer debt, which exacerbates, not remediates, our problem.

Said again, if the markets for sub-prime lending have driven consumer lending sky high, it must be because there is great profit in lending both to the typical consumers and to the higher-risk consumers who are overextended and may not pay their debts back. If one now reduces access to bankruptcy, it will increase the profitability of consumer lending and, one should expect, that consumer debt will be driven higher.[44]

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[40] Moss and Johnson at 13, citing Victor Sadd and Robert T. Williams, *Causes of Bankruptcies Among Consumers*, at 5–11 (Government Printing Office, 1933).

[41] *See* Elizabeth Warren, *The Bankruptcy Crisis*, 73 Ind. L. J. 1079, 1098 (Fall 1998). Warren's study reveals that the median nonmortgage debt-to-income ratio for chapter 7 debtors bas actually increased somewhat, from .87 in 1981 to 1.64 in 1997.

[42] "From 1981 to 1991, the real median family income of two samples of consumer bankrupts . . . fell by nearly 20 percent, from $22,436 to $18,000 (in 1991 dollars). The mean also fell from $23,642 to $20,535, a 13-percent decline." Moss and Johnson, *The Rise of Consumer Bankruptcy: Evolution, Revolution, or Both?*, at 45, citing Sullivan, Warren and Westbrook, *Consumer Debtors Ten Years Later: A Financial Comparison of Consumer Bankrupts 1981–1991*, 68 AM. BANKR. L. J. 128 (Spring 1994). Interestingly, the Moss and Johnson research shows income polarization among consumer debtors. In 1983, households with income under $50,000 (in 1992 dollars) held 42% of the nation's consumer debt and 45.3% of the nation's disposable income. By 1992, this group's share of all consumer debt had risen to 56.1%, while their share of disposable income had slipped to 35.5%. Moss and Johnson, *The Rise of Consumer Bankruptcy: Evolution, Revolution, or Both?*, at 41.

[43] *See* Marianne B. Culhane and Michaela M. White, *Taking the New Consumer Bankruptcy Model for a Test Drive: Means Testing Real Chapter 7 Debtors*, forthcoming in the American Bankruptcy Institute Law Review (Spring 1999).

[44] In this regard, Moss and Johnson suggest the possibility that reinvigorating usury laws could restrict the risk premium that lenders could gain from high-risk lenders, leading to the denial of credit to such lenders and reduced default and filing rates. *See* Moss and Johnson, *The Rise of Consumer Bankruptcy: Evolution, Revolution, or Both?*, at 51. I recognize, or course, that such a measure would require close scrutiny before implementation.

Instead, I believe reducing the consumer debt incurred by Americans would be healthy for each of us as individuals, for our body and our soul, and in the long run, healthy for our continuing prosperity as a nation.

But, in my experience very few persons indeed carry a high credit card balance because they intend to, or know they can and might, file bankruptcy.[45]

I believe the answer to unwise and unwarranted consumer debt lies elsewhere—perhaps in education, perhaps in reinstituting usury laws, perhaps in other lending restrictions or warnings, perhaps in the hard lessons of a recession, perhaps best in personal humility and responsibility taught at home.

IV. NEEDS-BASED BANKRUPTCY RELIEF: WHAT ARE ITS HISTORICAL UNDERPINNINGS? WHY IS THERE SUPPORT FOR IT NOW? WHAT IS THE ANSWER?

There are aspects of needs-based bankruptcy relief in our history and our current laws.

The Bankruptcy Act of 1867, for instance, provided that, in order for the debtor to receive a discharge, creditors had to be paid 50 cents on the dollar (later reduced to 30 cents) or receive the consent of a minority of creditors.[46]

Today our law dictates that drunk drivers and support payment obligors do not "need" (or deserve) a discharge of those related debts.[47]

And, of course, since 1984, Chapter 7 bankruptcy cases may be dismissed for "substantial abuse."[48]

In effect, these needs-based bankruptcy provisions in today's law are primarily requirements of debtor honesty, with ability to repay debts also considered under the "substantial abuse" rubric.[49]

As to why additional "needs-based", means testing, bankruptcy requirements are being advanced, I am unsure. As I have testified, I do not believe that a means test addresses the cause of increased bankruptcy filings.

Moreover, the most recent study I have seen shows that only a very small percentage of Chapter 7 debtors could pay back significant amounts of debts.[50] This supports my earlier testimony based on other studies which show most debtors earn relatively little and have high debt to earnings ratios.[51]

Moreover a litmus means test, akin to the ones which have recently been proposed, threatens to be impractical, inefficient and unjust.

In light of the facts as I see them, I support a more modest amendment to section 707(b) which allows the court the discretion it needs to weigh the totality of the debtor's circumstances[52] and then to eliminate those relatively fewer cases where

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[45] *See, e.g.*, Lawrence M. Ausubel, *The Failure of Competition in the Credit Card Market*, AM. ECON. REV. 50, 70 (March 1991) (explaining that many consumers systematically underestimate the extent of their current and future consumer credit consumption and the amount of their credit card balances, and therefore make sub-optimal borrowing decisions).

[46] *See* Charles Jordan Tabb, *The History of Bankruptcy Laws in America*, 3 AM. BANKR. INST. L. REV. 5, 20 (Spring 1995); Richard E. Coulson, *Consumer Abuse of Bankruptcy: An Evolving Philosophy of Debtor Qualification for Bankruptcy Discharge*, 62 Alb. L. Rev. 467, 480–81 (1998) (commenting that, under the 1841 and 1867 Acts, the main criteria for discharge were the debtor's candor and cooperation).

[47] 11 U.S.C. §§ 523(a)(5) and (9).

[48] 11 U.S.C. § 707(b); *See* Richard E. Coulson, *Consumer Abuse of Bankruptcy: An Evolving Philosophy of Debtor Qualification for Bankruptcy Discharge*, 62 Alb. L. Rev. 467, 495–97 (1998) ("[D]ismissal of a Chapter 7 case because a debtor could fund a Chapter 13 plan or otherwise pay past debts out of future earnings (which either is, or is not a factor in determining substantial abuse under Bankruptcy Code section 707(b)) constitutes . . . a radical change in federal bankruptcy policy.").

[49] Generally, under U.S. bankruptcy law, restrictions on a debtor's discharge have developed under several general categories: restrictions relating to conduct by the debtor that affects whether he or she merits the "bankruptcy bargain" (e.g. fraud in the bankruptcy schedules); restrictions that favor certain types of creditors (e.g. educational lenders and dependent children); restrictions that reflect a moral judgment regarding the conduct by which the debt was incurred (e.g. fraud, malice or drunk-driving); and, most recently, the debtor's ability to service his or her debt out of future income. Coulson, *Consumer Abuse of Bankruptcy: An Evolving Philosophy of Debtor Qualification for Bankruptcy Discharge*, 62 ALB. L. REV. at 484.

[50] *See* Marianne B. Culhane and Michaela M. White, *Taking the New Consumer Bankruptcy Model for a Test Drive: Means-Testing Real Chapter 7 Debtors*, forthcoming in the American Bankruptcy Institute Law Journal (Spring 1999) (data showing that approximately 97% of a random sample of 1,000 chapter 7 debtors had too little income to repay even 20% of their unsecured debts over a five-year period).

[51] *See supra*, notes 42 and 43.

[52] A survey of circuit-level decisions interpreting the "substantial abuse" standard of § 707(b) reveals that, generally, the two fundamental criteria are the debtor's ability to pay and the debtor's degree of honesty and cooperation; several circuit decisions have treated this as a "totality of the circumstances" standard. *See* Richard E. Coulson, *Consumer Abuse of Bankruptcy: An*

abuse exists. The Chapter 7 trustee should be authorized to review each case and bring appropriate section 707(b) motions before the court. Where relatively high income debtors (those earning over $60,000 a year) seek a discharge under Chapter 7, the debtor's creditors should be authorized to bring the section 707(b) motion before the court.[53]

V. DOES BANKRUPTCY BENEFIT OR HARM CREDITORS? WHAT OF THE CHAPTER 11 REFORM PROPOSALS?

I leave this discussion to other witnesses, except for the following.

In the beginning, bankruptcy was made for creditors.[54]

Today, bankruptcy protects creditors from the "snatch and grab" laws of each state, which otherwise require creditors to fight each other over the debtor's remains to their mutual disadvantage. Bankruptcy encourages equality of creditor treatment.[55]

In addition, through the fresh start for individuals and the reorganization of companies, bankruptcy rehabilitates persons and companies so that they may do better business with creditors in the future. In an economy driven in large part by consumption (and consumer credit), the discharge can effectively "recycle" consumers' economic capacity, giving them another chance to contribute, this time presumably more prudently, to the commercial economic process.[56]

I recently shared a courtroom with creditors and management of Geneva Steel Company, one of Utah's largest employers, which was forced into Chapter 11 by foreign steel dumped in our markets.

The events in that courtroom illustrated the importance of bankruptcy to creditors. Unsecured suppliers, owed perhaps $25 million, unsecured bondholders owed over $325 million, the secured bank lenders owed about $73 million, and Geneva's employees—all joined in supporting Geneva's Chapter 11 case and in supporting new financing for Geneva's operations even though the new financing would have a higher bankruptcy repayment priority than their own obligations.

This broad support was based, I believe, on at least three factors:

First, Chapter 11 provides a mechanism for saving Geneva's going concern value and improving its viability so that creditors and employees can be paid more than if it failed and were liquidated.

Second, Geneva's creditors knew that in Chapter 11 they would have much to say about how Geneva would be restructured. Some Government receiver wouldn't be making the decisions; they would.

Third, Geneva's creditors understood that they would be favored above shareholders and that creditors would be treated fairly as between each other.

Geneva's reorganization may succeed or fail (I believe it will succeed), but those who stand to lose and win the most, the creditors, will be empowered by the bankruptcy law to help decide the course of its reorganization.

Evolving Philosophy of Debtor Qualification for Bankruptcy Discharge, 62 Alb. L. Rev. at 506–16 (discussing *In re Kelly*, 841 F.2d 908 (9th Cir. 1988); *In re Walton*, 866 F.2d 981 (8th Cir. 1989); *U.S. Trustee* v. *Harris*, 960 F.2d 74 (8th Cir. 1992); *In re Krohn*, 886 F.2d 123 (6th Cir. 1989); *Green* v. *Staples (In re Green)*, 934 F.2d 568 (4th Cir. 1991); *Kestell* v. *Kestell (In re Kestell)*, 99 F.3d 146 (4th Cir. 1996); *In re Lamanna*, 153 F.3d 1 (1st Cir. 1998)).

[53] This is the proposal of the National Bankruptcy Conference.

[54] *See In re Morris*, 12 B.R. 321, 330–32 (Bankr. N.D. Ill. 1981) (explaining that bankruptcy was originally a creditor's remedy against merchant debtors, while the first insolvency laws allowed an honest and cooperative debtor to come forward, pledge his assets, and be spared incarceration). The early English bankruptcy acts, such as the Bankruptcy Act of 13 Elizabeth (1570) restricted the remedy of bankruptcy to merchants. Creditors exercised the remedy in order to assist their collection efforts. Bankruptcy was so limited by successive laws in England until 1861 and in the United States until passage of the Bankruptcy Act of 1841. *See* Tabb, *The Historical Evolution of the Bankruptcy Discharge*, 65 AM. BANKR. L. J. at 327, 335, 353. The etymology of the term "bankrupt" betrays this original limitation to merchants. Under the early Italian bankruptcy laws, which also applied only to merchants and treated debtors effectively as outlaws, a defaulting debtor's bench (*banca*), or trading place was subject to being destroyed (*rotta*), hence the Italian term *bancarotta*, the French *banqueroute*, the Spanish *bancarota*, and the English "bankrupt." *See* Vern Countryman, *Bankruptcy and the Individual Debtor—And a Modest Proposal to Return to the Seventeenth Century*, 32 CATH. U. L. REV. at 810.

[55] *See* Susan Block-Lieb, *Book Review: A Humanistic Vision of Bankruptcy Law*, 6 AM. BANKR. INST. L. REV. 471, 485–86 (Winter 1998) (commenting on the increasing domination of bankruptcy theory by law-and-economics analysis, including the "common pool" theories and critiques thereof; and reviewing Karen Gross' *Failure and Forgiveness: Rebalancing the Bankruptcy System* (1997), which proposes equality of distribution as a *presumption*, which is rebuttable by individual creditors who can prove that equality of distribution will lead to inequitable outcomes (e.g. where, *ceteris paribus*, a 10% distribution will devastate a mom-and-pop store as creditor while only marginally affecting a multinational conglomerate as a creditor)).

[56] *See supra* note 23.

The American system of Chapter 11 which allows creditors and owners of a troubled company to negotiate and work together to find the best solutions far outweighs, in my opinion, the government imposed restructurings and liquidations found in the bankruptcy laws of most other countries. It is my hope that Congress will not unbalance this mechanism by continuing to listen to individual creditor and interest groups who seek individual advantages under the law. To do so is to reimpose the evils of "snatch and grab" law and undermine the equity and equilibrium of the reorganization process.

Mr. GEKAS [presiding]. We thank the gentleman.

We turn to Judge Lee.

STATEMENT OF JOE LEE, UNITED STATES BANKRUPTCY JUDGE, EASTERN DISTRICT OF KENTUCKY, LEXINGTON, KY

Mr. LEE. I, too, would like to say something about the stigma of bankruptcy. I think that the reason people think there is no stigma to bankruptcy these days is because they listen to the radio and television ads of automobile dealers, furniture dealers, carpet dealers saying "bad credit, no credit, bankrupt, come on in, we will sell you goods and services."

Hearing that, people subliminally think obviously there is no longer a stigma to bankruptcy, but I have served on the bankruptcy bench for 37 years, and 18 of those years was under the prior law when we presided over meetings of creditors and listened to the interrogation of debtors. Even under the new law for a period of several years, we had discharge hearings wherein we supervised the reaffirmation agreements by debtors and listened to their stories.

I do not find these people to be cavalier. They are all contrite, very concerned about having to take bankruptcy, and if you think about it a minute, you will understand why. These people have neighbors; they have mothers, fathers, uncles, and they have a church group that they go to. They have a place of work that they go to, and it is ridiculous to say that debtors walking in those shoes find no stigma in bankruptcy. Obviously, they are looked on by their neighbors, their fellow employees, their friends, their church group as having gone through bankruptcy, and there is a stigma to bankruptcy.

I would end my statement by pointing out that back in 1971, the Brookings Institution did a study of bankruptcy at the request of the Administrative Office of U.S. Courts, and that study was funded by a grant and not by an industry. They asked the question whether it would be more beneficial to society to require debtors to repay their debts as opposed to having those debts discharged in bankruptcy.

Their conclusion was that it was virtually impossible to tell whether it would benefit society more to come up with a needs-based bankruptcy system such as this and require debtors to pay debts, as opposed to the decreased consumption that would occur by those debtors during the period of repayment, and they came to the conclusion that it was sort of a dog fall as far as society was concerned to require payment of debts and think that that would benefit society.

I also point out in my paper, as Judge Mabey has and others, that there was an event in 1978 that triggered an enormous increase in bankruptcy filings in subsequent years, but it was not the enactment of the Bankruptcy Reform Act of 1978. Rather, it was the decision a few months later in December 1978 in the Marquette case in which the issue was this. A National Bank in Omaha, Nebraska, had issued credit cards, BankAmericards, to citizens of Minnesota, and the Attorney General of Minnesota contested the rate on those credit cards, which was 18 percent under Nebraska law. The maximum rate available in Minnesota was 12 percent.

The Supreme Court held that under the National Bank Act, the interest rate that the National Bank could charge was the interest rate of the State in which the bank was located. In other words, the National Bank could export its interest rate to citizens of other states without running afoul of the usury laws of that State.

Almost immediately, a couple of States, South Dakota and Delaware, enacted statutes abolishing usury laws and statutes favorable to banking, and almost immediately, Citicorp opened a credit card processing unit and a National Bank in Sioux Falls, South Dakota, and moved its credit card operations from New York City to South Dakota.

Almost immediately, four National Banks in Maryland, moved their credit card operations to Delaware, and they did that because the Maryland State legislature had refused to raise interest rates. So it was the Supreme Court, really, and not the Bankruptcy Code that opened up this Pandora's box.

I see my time has expired.

[The prepared statement of Judge Lee follows:]

PREPARED STATEMENT OF JOE LEE, UNITED STATES BANKRUPTCY JUDGE, EASTERN DISTRICT OF KENTUCKY, LEXINGTON, KY

SUMMARY

My statement is presented in three parts an incorporates exhibits and charts which are attached at the end of Part II.

Part I: The impact on the economy and society if H.R. 833 is enacted has not been fully considered. Two million families could be forced to live at the poverty level while they repay a fractions of their debt.

Part II: There was an event in 1978 that triggered an increase in consumer bankruptcy cases, but that event was not the enactment of the Bankruptcy Reform Act of 1978. By way of comparison, personal bankruptcy filings in Canada have increased significantly since 1968—not because of any changes in the bankruptcy laws there, but because of the entry and development of the credit card industry in Canada in 1968. Deregulation of the credit card industry in the United States, which began in 1978, has resulted in an increase in the number of consumers overburdened by credit card debt seeking relief through bankruptcy.

Part III: Congress has considered and has wisely rejected compulsory chapter 13 proceedings on other occasions. As early as 1937 Congress recognized that an effective and sensible debt repayment plan would have to be voluntary and of relatively short duration. Compulsory chapter 13 legislation may encourage predatory extensions of credit, just as Congress recognized in 1968 that unrestricted wage garnishments encouraged the making of predatory extensions of credit.

PART I

HISTORY AND SIGNIFICANCE OF THE "FRESH START" DISCHARGE UNDER AMERICAN CONSUMER BANKRUPTCY LAW: WHY DO WE LET DEBTORS "WALK AWAY FROM THEIR DEBTS?"

The "Fresh Start" discharge relieves the honest debtor of the burden of overwhelming debt and restores the debtor as a productive member of society capable of supporting himself and his family.

The belief that requiring debtors to repay some or all of their debts will bring down interest rates and prices is largely a myth.

In his book "The Indebted Society, The Anatomy of an Ongoing Disaster," Little Brown and Company, 1996, Professor James Medoff, the Meyer Kestnbaum Professor of Labor and Industry at Harvard University, points out that between 1980 and 1992, when the federal funds rate (the interest that banks charge for overnight loans) fell from 13.4% to 3.5%, a drop of nearly 10 percentage points, the average credit card interest rate rose from 17.3% to 17.8%.[1] Professor Medoff suggests that during the 1980s, when interest rates were high, lenders learned a valuable lesson; consumer debtors in general pay very little attention to interest rates.

The small reduction in the average credit card interest rate that has occurred since 1992 is due in large measure to the increased reliance by credit card issuers on "teaser rates" to entice more consumers to open new credit card accounts. See Chart 7 attached to my statement. In 1993, credit card banks were nearly four times as profitable as all commercial banks. Despite the slight decrease in the average credit card interest rate, credit card banks remain twice as profitable as commercial banks.[2] While the charge-off rate on credit cards may have increased due to the marketing of cards to college and high school students and debtors with subprime (less than good) credit histories, in applications to purchase or merge banks the applicants tell regulators that such acquisitions and mergers will reduce costs and save customers money. If the latter is true, such savings should more than offset the increase in write off of credit card debt.[3]

We are told that consumer spending is the engine that accounts for two-thirds of the expansion of our economy, and that consumer confidence is critical to consumer spending. One of the unintended consequences of this proposed legislation is that it tinkers with the engine that drives our economy.

In 1971 the Brookings Institution published a study of the United States bankruptcy system which it had undertaken at the request of the Judicial Conference of the United States.[4] Under the heading "Who Bears the Cost" the authors of this study discuss the question whether requiring debtors to repay some of their debt would be good for the economy. Their ultimate conclusion was that it was impossible to tell whether the positive effect on the economy of forcing debtors to repay old debt would outweigh the effect of reduced spending and consumption by such debtors during the period of repayment.

As I understand the bill presently under consideration, it is designed to force approximately 30% of individual debtors filing for relief under the Bankruptcy Code into debt repayment plans. These debtors and their families, including children, would be required to live at poverty level for 5 years while repaying some portion of the family debt. Based on present day filings this could mean that each year approximately 400,000 families would be relegated to living at poverty level. This would be in addition to families of low wage earners already living at poverty level. At the end of a five-year period (400,000 x 5) there could be a constant number of 2,000,000 families forced to live at poverty level in addition to the millions of minimum wage earners and their families who now exist on poverty-level wages.

However, these 2,000,000 families who are forced to live at poverty level under coerced debt repayment plans will be worse off than other low wage, poverty level families. This is because the income of these 2,000,000 families may theoretically exceed poverty level and thus they may not qualify for earned income credit tax refunds, school lunch programs, food stamps, or other subsistence provided to families with below poverty level income. These families will be worse off than other poor families because they will be living at poverty level for up to five years only due to the requirement that they repay some of the family debt.

While mercifully we have abolished imprisonment for debt, this needs-based bankruptcy legislation may be tantamount to sentencing 2 million families to home incarceration for 3–5 years, simply because they will not be able to afford to go anywhere but church.

At a time when one of the objectives of our government is to raise all families above poverty level it seems inconsistent to force into poverty those families who for whatever reason can't pay their VISA and MasterCard bills.

Before enacting this legislation Congress should study the effect on the economy of severely restricting consumer spending of 2,000,000 families whose ability to

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[1] James Medoff and Andrew Harless, *The Indebted Society: Anatomy of an Ongoing Disaster*, at 12–13.

[2] Federal Reserve Board, *The Profitability of Credit Card Operations of Depository Institutions* (August 1997).

[3] Arthur E. Wilmarth, Jr., *Too Good to be True? The Unfulfilled Promises Behind Big Bank Mergers*, 2 Stan. J.L. Bus. & Fin. 1 (1995).

[4] See David T. Stanley and Marjorie Girth, *Bankruptcy: Problem, Process, Reform*. The Brookings Institution, Washington, D.C. 1971.

spend will in no way be enhanced by government subsidies. Congress should also study the effect on consumer confidence of the proposed punitive treatment of these families.

Needs-based bankruptcy also may discourage entrepreneurship and affect our economy in that respect as well. Most small businesses, about 80% of which fail in two years, are started by individuals. These businesses, even those that do not survive, provide a significant number of new jobs annually. Quite a number of personal bankruptcy cases are filed by individuals to escape debt incurred in a failed business venture. Under this needs-based bankruptcy legislation, these individuals, if they subsequently have become employed, may have to live at poverty level for 3–5 years while repaying old business debt. This change in the bankruptcy laws could discourage entrepreneurs from undertaking a new business venture. And since the government professes to encourage entrepreneurship, we should think twice about enacting a bankruptcy law that does just the opposite.

Against this background it makes no sense to project that this bill will save American families $550 per year in reduced interest and cost of goods and services. This projection apparently is based on industry-funded research of specious origin.[5]

In another part of my statement I have pointed out that an earlier study conducted by the Credit Research Center in 1982 concluded that in the absence of bankruptcy only ¼ of the indebtedness discharged in bankruptcy would be collectible by creditors in any event. That seems obvious because of the fees charged by collection attorneys and the unlikely possibility of collecting an account in full. Thus, the $550 figure being bandied about as a savings to American families should, at a minimum, be divided by four so that the real savings, if any, would be more in the range of $137, and this would be offset by the increased cost to the Government of administering the changes in the law mandated by H.R. 833.

This subcommittee should be cautious about enacting legislation that serves the ends of VISA and MasterCard while they are defendants in an action in the Southern District of New York in which the Justice Department is seeking to restrain them from violations of the antitrust laws. In my view a reduction in credit card rates may depend largely on the success of the Justice Department in that action. There is no good reason why this legislation shouldn't be delayed pending the outcome of that action.[6]

PART II

THE IMPACT OF THE 1978 BANKRUPTCY REFORM ACT: DID IT LEAD TO INCREASED FILINGS? IF NOT, WHAT HAS?

There was an event in 1978 that triggered an increase in individual bankruptcy cases, but that event was not the enactment of the Bankruptcy Reform Act of 1978.[7]

The event in 1978, which was a catalyst for the enormous expansion of consumer debt—particularly credit card debt—as well as the accompanying increase in consumer bankruptcy filings, was the decision of the U.S. Supreme Court in what is known as the *Marquette* case.[8] This benchmark decision was handed down by the U.S. Supreme Court on December 18, 1978, approximately a month and a half after the November 6, 1978 date of enactment of the Bankruptcy Reform Act.

In the *Marquette* case the Supreme Court held that a national bank located in Omaha, Nebraska could charge residents of Minnesota to whom it had issued BankAmericard credit cards the rate of interest allowed by the law of the state in which the bank was located even though the rate was greater than the rate permitted by the law of Minnesota. The Minnesota Attorney General had argued that the maximum applicable rate was the 12% rate fixed by the law of Minnesota rather than the 18% rate allowed by the law of Nebraska. The Supreme Court held that under the National Bank Act the applicable rate was that permitted by the law of the state in which the national bank was located. In other words, a national bank may "export" the interest rate of the state in which the bank is located to its out of state customers and credit card holders without running afoul of the usury laws of the

[5] Please refer to Part III of my statement.

[6] *United States* v. *Visa U.S.A., Inc., Visa International Corp., and Mastercard International, Inc.*, Civil Action No. 98–CIV–7076 (S.D.N.Y).

[7] Mr. Hyde and Mr. Conyers are the only current members of the House Judiciary Committee who were on the committee in 1978. Consequently most of the present members are probably unaware of the fact the 1978 Bankruptcy Reform Act enjoyed bipartisan support to the extent that the bill in its final form passed the House on the Consent Calendar. That would not have occurred if the law were radically pro-debtor as the consumer credit special interest groups would now have Congress believe.

[8] *Marquette National Bank of Minneapolis* v. *First Omaha Service Corporation*, 439 U.S. 299, 99 S.Ct. 540, 58 L.Ed.2d 534 (1978).

customers' home states.[9] This decision in effect "deregulated" control of interest rates by individual states and emasculated state usury laws.

Some states acted quickly to deregulate interest rates and other banking functions to attract banks and related entities. Two such states were South Dakota and Delaware.[10]

Citicorp was one of the first lenders to take advantage of deregulation at the state level. In 1981 Citicorp established a new national bank and credit card processing center at Sioux Falls, South Dakota and moved that bank's credit card operations from New York City to Sioux Falls.

In 1982 Maryland Bank, N.A., the state's largest bank at the time, moved its credit card operations to Delaware and was followed shortly thereafter by First National Bank of Maryland, Equitable Trust Co., and Suburban Bank. These four banks moved their credit card operations to Delaware after the Maryland state legislature refused to relax the state's usury laws.[11]

The Supreme Court had opened Pandora's box. The race was on among the states to relax usury laws to attract banks; the race was on among banks to establish affiliate national banks in states that had relaxed or abolished usury laws.

In 1987 the Bank Holding Company Act was amended by the Competitive Equality Banking Act of 1987 to permit ownership of federally-chartered credit card banks by entities other than bank holding companies. This has permitted the creation of national banks by many retailers such as Chevron, Dillards, Fingerhut, J.C. Penney, Sears, and Circuit City Stores, Inc. These retail affiliate credit card banks issue credit cards to customers for use in charging purchases at the retailer's store. The interest rate charged on these credit cards typically is four or five percentage points higher than the interest on regular credit cards. For example, the interest rate on a Circuit City credit card issued by First North American National Bank of Marietta, Georgia is 24.5%. The interest rate on a Sears credit card is 22%. By use of these credit cards retailers are able to circumvent any remaining applicable state usury laws that might otherwise control the interest rate on consumer purchases.

Attached to my statement as Exhibit No. 2 is a list of approximately 70 credit card banks chartered by the Comptroller of the Currency, the administrator of national banks. You will note that most of these banks have been chartered since 1978.

This imaginative use of credit card banks has caused consumer credit outstanding to rise steadily since 1978 and personal bankruptcies to increase in tandem with the growth of consumer credit outstanding. See Charts 1–4 attached to my statement.

Should there be "doubting Thomases" about the growth of consumer credit being virtually the only real cause for the increase in personal bankruptcies we need only look at the Canadian experience.

Interest rates in Canada have been deregulated at least since 1886, but personal bankruptcies there were not a noticeable problem prior to 1968. In 1968, two years after the development of the Visa and MasterCard associations in the United States, Visa entered Canada, resulting in dramatic growth in credit card loans. As a result personal bankruptcies started rising sooner in Canada than in the United States. This cannot be blamed on changes in Canadian bankruptcy laws because Canadian bankruptcy laws had not been changed. Personal bankruptcies grew sharply and immediately after Visa association entered Canada. From 1966 to 1976, the personal bankruptcy rate in Canada grew 340 percent. Over the same period, the personal bankruptcy rate in the United States grew by only 8 percent. One explanation for this difference in rates may be that state usury laws were limiting the availability of credit in the United States during that period (which was prior to the decision in the *Marquette* case), while the absence of usury ceilings in Canada was permitting the expansion of credit card debt to more high risk borrowers.[12]

After interest rate deregulation in the United States resulting from the *Marquette* decision, over the next decade the personal bankruptcy rate in the United States and Canada follow a remarkably similar pattern. Between 1976 and 1986, the Cana-

[9] The Supreme Court later held that the National Banking Act permits national banks to "export" late payment fees, cash advance fees, and other fees relating to an extension of credit. *Smiley* v. *Citibank (South Dakota), N.A.*, 517 U.S. 735, 116 S.Ct. 1730, 135 L.Ed.2d 25 (1996).

[10] Ellis, *The Effect of Consumer Interest Rate Deregulation on Credit Card Volumes, Charge-Offs, and the Personal Bankruptcy Rate, Bank Trends*, March 1998, No. 98–05. *Bank Trends* is a publication of the Federal Deposit Insurance Corporation Division of Insurance. Ms. Ellis is a Senior Analyst in the Economic Analysis Section of the Division of Insurance of the FDIC. A copy of this article is attached to my statement as Exhibit No. 1.

[11] *Id.*

[12] Ellis at p. 9, fn. 4.

dian bankruptcy rate grew by approximately 93 percent, and the U.S. bankruptcy rate grew by 72 percent. In the decade 1986–1996, as the credit card industry underwent rapid innovation and expansion, personal bankruptcy rates in both countries grew dramatically. In Canada, the personal bankruptcy rate grew 225 percent; in the United states it grew 123 percent.[13]

The Canadian experience indicates that changes in our federal bankruptcy laws have not been a significant factor in the rise of personal bankruptcies in the United States. During all of this period the unchanged Canadian bankruptcy laws have been far more restrictive than the U.S. bankruptcy laws, but those laws were not effective against the onslaught of unsecured credit foisted on debtors by credit card issuers. Credit card lenders may be pointing the finger at the Bankruptcy Reform Act of 1978 to detract Congressional and public attention from the fact that their credit card operations are the real source of the problem.

Between 1993 and 1998 bank credit card loans in the United States doubled from $223 billion to nearly $500 billion, and personal bankruptcy filings increased accordingly. See cbarts 5–6 attached to my statement. This surge in credit card debt and personal bankruptcies occurred primarily because of relaxation in banking laws and regulations.

Since the early 1990's banks increasingly have resorted to securitizing credit card accounts receivable, and banking laws and regulations have been changed to facilitate these transactions. Most are familiar with the practice of bundling home mortgage loans or even car loans and selling them as a package to investors. But the practice of bundling unsecured credit card receivables and selling them in a package to investors is a relatively new pbenomenon. Congress and federal regulators have been persuaded to make changes in the law and regulations to facilitate these transactions. The proliferation of credit card-backed securities has produced hefty profits for lenders and investors but has left as its legacy a society drowning in credit card debt.

Credit card securitizations are usually structured by the issuing bank as non-recourse sales of pools of credit card receivables to an entity such as a Master Trust. The trust in turn issues to investors securities similar to bonds. The trust uses money it receives from investors to purchase credit card receivables from banks. The banks then use the money they receive from the trust to make new loans.

The investors in credit card-backed securities are usually mutual funds, insurance companies, corporations, and other banks, foreign and domestic. Investors receive periodic interest payments over time, and receive payment of principal when the securities mature (e.g., 5–10 years). The cash flow generated as consumers repay their credit card debt is used to make interest payments to investors. To ensure there will be sufficient funds over time to make interest payments to investors, the bank issuing the credit cards which back the securities is obligated to maintain a minimum level of credit card receivables in the asset pool. In other words, as consumers repay tbeir credit card debt, the total amount of credit card receivables held by the trust must be replenished. In effect the bank is obligated to investors to continue generating credit card receivables during the life of the security. Receivables are easily generated so long as consumers stay in debt. In the past five years competition in the credit card industry has been driven by two factors: (1) profit margins reflected by the difference between the high interest rates charged to consumers and the cost of funds to the bank (see chart 7); and (2) the need to generate credit card receivables for securitizations (see chart 6).

Apparently some banks are buying or merging with other banks in order to acquire credit card receivables, which are then sold on the secondary market for funds to facilitate the purchase or merger arrangement.

In 1994 the President signed into law Riegle-Neal Interstate Banking and Branching Act, Pub. L. No. 103–328, 108 Stat. 2338 (1994), which significantly reduced geographic restrictions on interstate banking activity. This new law permits bank holding companies to purchase subsidiary banks across state lines without regard to restrictions on out-of-state acquisitions imposed by state law. It also permits interstate bank mergers regardless of state law. The act also permits a national bank to establish and operate a de novo branch in a state other than the bank's home state.

This act has led to acquisitions of banks by bank holding companies and to bank mergers that may result in the sale or transfer of credit card accounts of bank customers. Upon acquisition of such accounts the acquiring banks apparently are free to impose other terms on the cardholder, including an increase in the interest rate as a means of paying for the acquisition.

[13] Id. at p. 10.

When home mortgages or car loans are sold, as they frequently are, the entity acquiring such mortgages or car loans cannot change the terms of payment or interest rate. This apparently is not so with respect to credit card accounts that are sold.[14]

In any event 5 large banks now own or control 43% of all credit card debt. These 5 financial institutions, together with 45 other banks, 50 financial conglomerates in all, control 81.5% of the approximately $500 billion in credit card loans. All other banks and financial institutions in the United States control only 18.5% of outstanding credit card debts. See chart 8 attached to my statement.

Congress and banking regulators have facilitated the enormous expansion of consumer credit and have encouraged the consumer credit industry's reliance on securitizations. When a bank securitizes its credit card receivables it is able to remove the loan from its balance sheet, thereby reducing the amount of capital it must retain. Legislation effective on September 1, 1997 was intended to facilitate the securitization of credit card receivables and other consumer debt instruments, such as home equity loans, by utilizing an entity called a Financial Asset Securitization Investment Trust (FASIT). A FASIT can issue securities that will be treated as debt for federal income taxation purposes. Any taxable income or net loss will flow through to the equity owner of the FASIT; the FASIT itself is not a taxable entity.[15] A rule clarified by the Comptroller of the Currency on December 2, 1996 permits national banks to invest in securities backed by credit card receivables and other consumer loan receivables. This rule increased the amount of capital and surplus a federally-chartered bank may invest in asset-backed securities from 10% to 25%.[16]

In 1996 Congress opened the door to permit savings associations, or "thrifts," to engage in credit card lending. In 1997, the Office of Thrift Supervision promulgated a rule which permits thrifts to make credit card loans.[17]

Amendments to the Fair Credit Reporting Act in 1997 made it much easier for lenders to make the familiar "you have been pre-approved" offers of credit through mass advertising to consumers who have not applied for loans. Lenders submit to credit reporting agencies not names but merely a profile of consumers to whom the lender may wish to extend an offer of credit. Previous to the amendments the credit reporting agency was permitted to furnish the lender the names and addresses of consumers who fit the profile only if the lender agreed to make a "firm offer" of credit to every consumer on the list. The recent amendment emasculates the definition of "firm offer," thereby permitting creditors to offer "pre-approved" credit to anyone.[18]

It has been reported that credit card banks mailed 3 billion unsolicited offers of credit either by negotiable checks or preapproved credit cards, or home equity loans to debtors during 1997. That is approximately 30 such offers to every household in the United States, or another way of putting it, approximately eleven such offers for every man, woman and child in the United States.[19] According to American Banker, since 1996 Fleet Financial Group has mailed out 4.5 million checks in denominations of $3,000 to $10,000 inviting prescreened debtors who had not solicited loans to simply endorse the checks (thereby acknowledging the loan) and use the money to pay taxes or spruce up their houses, etc. Other lenders, including Chase Manhattan Corp., have engaged in similar check mailings.[20]

Some such offers are being mailed to debtors with subprime (less than good) credit ratings, of which the lenders are fully aware. These are the same lenders who want to preclude debtors from relief under chapter 7 of the Bankruptcy Code in the event of default and force such debtors into a repayment plan under chapter 13. In other words, they want to close the bankruptcy escape hatch as a hedge against losses on their risky, improvident loan procedures.

In a speech before the American Bankers Association on September 27, 1998, Julie L. Williams, Acting Comptroller of the Currency, made these points:

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[14] See *Sales of Credit Card Accounts are Hurting Many Consumers, New York Times*, March 2, 1999, page 1, column 1.

[15] See FDIC, *FASITS Promise to Change the ABS Market*, FDIC Regional Outlook (Third Quarter 1997).

[16] See Final Rule, 61 FR 63972 (December 2, 1996).

[17] 12 U.S.C. § 1464(c)(1)(T): Final Rule, 62 FR 15819 (Apr. 3, 1997).

[18] 15 U.S.C. § 1681b(c).

[19] See, Jane Bryant Quinn, *How Credit Card Issuers Fuel Overborrowing*, Washington Post, May 17, 1998, at H02; Vince Passaro, *Who'll Stop the Drain? Reflections on the Art of Going Broke*, Harper's Magazine, August 1998, at 35, 38.

[20] See American Banker, Vol. 162, No. 227, Nov. 25, 1997.

. . . Beginning in 1993 consumer loans overtook commercial loans as a percentage of all commercial bank assets. Although the balance of these bank assets has again recently converged, analysis shows that this is the result not of any slowdown in the pace of consumer [loan] originations. Instead, more and more banks—of all sizes—are finding it easy and advantageous to securitize consumer assets and thus take [the loans] off their books, freeing them to make more loans. . . .

. . . Consumer lending remains one of the few places on the banking landscape where profit margins have held up in the face of growing competition. . . .

. . . .

. . . Between 1993 and 1998, consumer credit outstanding—excluding home mortgage debt—rose more than fifty percent, reaching more than one and a quarter trillion dollars. And this does not include another $2 trillion in unused credit lines—credit that consumers can tap at their convenience. Together, these numbers nearly equal the total deposits in all U.S. commercial banks.

These are staggering sums. But their true significance becomes clearer in the context of the overall performance of our economy. For while consumer credit outstanding was going up roughly 50 percent between 1993 and mid-1998, personal income has risen only half as fast during the same period. And debt service payments as a percent of disposable personal income are nearly the highest they have ever been.

. . . .

We should hardly be surprised, then, to see deterioration in the performance of some categories of consumer loans and the increase in the personal bankruptcies in recent years. . . .

. . . .

Many American households are overextended, and there is plenty of blame to go around. . . . While some [lenders] continue to exercise restraint and common sense, other lenders have aggressively targeted those consumer groups most likely to be seduced by easy credit: college and even high school students; recent bankrupts; and people who are already overextended. Some issuers have exploited loopholes in the law to get unsolicited credit cards into customers' hands; others resort to heavy-handed and sly marketing practices, such as "teaser" interest rates.

A particular trouble spot is the fast-growing home equity market. In the three years between 1994 and 1997, the dollar value of commercial banks' home equity loans increased by more than 35 percent.

Home equity loans are usually marketed to, and used by, consumers as a means to consolidate credit card debt. According to a recent study, over the past 24 months 4.2 million American households have converted $26 billion of credit card debt into home equity mortgage debt. For many consumers, this makes sense. . . . But the same study also shows that only a third of the 4.2 million households that had consolidated their unsecured debt were still credit card debt-free at the end of the study period. To varying degrees, the others had "reloaded" their credit cards with new purchases, leaving them worse off than before in terms of their total debt burden. Worse still, they placed their homes in jeopardy.

Ms. Williams characterizes the rise of consumer banking as synonymous with the democratization of credit. But she also points out that no one wins when individuals receive too much credit or credit they cannot afford. No one wins when a consumer falls behind or declares personal bankruptcy or loses a home to foreclosure.

Unfortunately some of the sponsors and proponents of the legislation presently under consideration have made statements suggesting the current increase in individual bankruptcy filings during good economic times is unprecedented.

Actually, an increase in individual bankruptcy filings in good economic times is not at all unusual.

In testimony before the Committee on Banking and Financial Services, U.S. House of Representatives, September 12, 1996, at pages 127–128, Ricki Helfer, Chairman of the Federal Deposit Insurance Corporation, stated:

> [r]ising consumer delinquency and charge-off rates during an economic expansion—like the present rising rates—are not unusual. During the last economic expansion from 1985 to 1989, consumer delinquency and charge-off rates also rose.

In testimony before the Subcommittee on Financial Institutions and Regulatory Relief of the Senate Banking Committee, on July 24, 1996, Mr. James Chessen, the Chief Economist of the American Bankers Association stated:

> It is interesting to note that bankruptcies have risen during recent periods of economic growth. In the 1980's, despite the longest postwar expansion, bankruptcies rose steadily.
>
> . . . Consumer debt has expanded because banks are very healthy and can meet the growing consumer demands for credit.
>
> . . . [R]ising delinquencies should be closely monitored, but there is no reason for alarm. Banks are already becoming more cautious and have already taken steps to reduce their exposure.
>
> In fact, the banking industry holds a lower volume of consumer loans, including credit cards, than they did at the start of the year. They have already responded to rising delinquencies.
>
> Moreover, the potential losses are not great enough to create substantial problems for the banking industry. First, the exposure per individual customer is very small. Second, banks' loan portfolios are well diversified, and third, the industry has record levels of capital and reserves to enable it to easily handle the highest levels of consumer losses. . . .
>
> . . .
>
> Given the strong financial condition of the banking industry, consumer delinquencies pose no serious threat.
>
> . . .
>
> Prudent lending in the face of rising delinquencies is appropriate. And I have to say that we need to be sure that the regulators do not overreact and slam the brakes on consumer lending.

Thus, when representatives of the American Bankers Association appear before the Senate Banking subcommittee that oversees their lending activities, they tell the subcommittee that potential losses on consumer loans are not great enough to create substantial problems for the banking industry; that regulators should not overreact and slam the brakes on consumer lending.

When representatives of the consumer loan segment of the American Bankers Association appear before this subcommittee they tell the subcommittee that the number of consumer bankruptcies is causing them serious problems and that the solution is to slam the door on the access of consumer debtors to relief under the Bankruptcy Code.

The consumer loan industry can't have it both ways. They can't say there is no problem, don't overreact and regulate us; there is a problem, overreact and regulate our customers.

> Mr. Chessen told the Senate Banking subcommittee what is essentially the truth.
>
> The growth of consumer debt has outstripped the growth of disposable income and pushed consumer debt burdens to historically high levels. The rising consumer delinquencies are the best evidence some consumers are reaching the limits of their debt.

This statement by a spokesman for the banking industry pretty well concedes that the reason for the rise in delinquencies and bankruptcies is historically high debt levels of consumers and not the alleged laxity of the bankruptcy laws.

Clearly, the extraordinary and enormous ballooning of consumer credit has been made possible by actions of the courts, Congress, and regulatory agencies, through interest rate deregulation and the easing of restrictions on consumer lending. It is these actions which are responsible for the increase in individual bankruptcy filings. Those who blame the 1978 Bankruptcy Reform Act for the increase in individual bankruptcy filings are misleading the public and Congress.

PART III

NEEDS-BASED BANKRUPTCY RELIEF: WHAT ARE ITS HISTORICAL UNDERPINNINGS? WHY IS THERE SUPPORT OF IT NOW?

My colleagues on the panel have done an excellent job covering this subject. I would like to add a few thoughts and a footnote.[21]

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[21] Although the first bankruptcy act, the Act of April 4, 1800, was repealed on December 19, 1903, during the short period the Act was in effect somewhat less than 500 cases were filed. The mot notable case was that of Robert Morris, financier and one of the signers of the Constitution. Robert Morris had languished in debtor's prison in Philadelphia for 3½ years when an in-

A major reason the House Judiciary Committee in the past consistently has rejected mandated chapter 13 is concern over whether involuntary chapter 13 proceedings may violate the Thirteenth Amendment, which prohibits involuntary servitude. Though it has never been tested in the chapter 13 context, it has been suggested that forcing an individual to work for creditors would violate this prohibition. See House Report No. 95–595, 95th Cong., 1st Sess., pg. 120.

The following quote is excerpted from a statement of Professor Vern Countryman of Harvard Law School in oversight hearings on personal bankruptcy before the Subcommittee on Monopolies and Commercial Law of the House Judiciary Committee on October 22, 1981, March 23, 25, April 28, May 20, and June 16, 1982, at page 435.

> (1) As was said by a witness fifty years ago, opposing a proposition that we adopt the English practice of suspending bankruptcy discharges until the debtor has paid off all, or at least a substantial part, of existing debts from future earnings (which is the essence of the proposals here), such a proposition is "contrary to the genius of our institutions." Indeed, that proposal was, I believe, the only bankruptcy proposal in the history of this country to be characterized by another witness as "Un-American." Joint Hearings before Subcommittees of the House and Senate Judiciary Committees on S. 3863, 72nd Cong. 1st Sess., pp. 546, 641, 753 (1932). The Thirteenth Amendment provides that, except as a punishment for crime, involuntary servitude shall not exist in the United States. Acting under that Amendment, the Congress long ago abolished peonage in the United States (42 U.S.C. § 1984) and made it a crime to hold a person in a condition of peonage (18 U.S.C. § 1581). In upholding the constitutionality of these statutes, the Supreme Court defined peonage as "a status or condition of compulsory service based on the indebtedness of the peon to the master. The basal fact is indebtedness." *Clyatt* v. *United States*, 197 U.S. 207, 215 (1904). The Supreme Court has also invalidated state peonage laws under the Thirteenth Amendment. *Bailey* v. *Alabama*, 219 U.S. 219 (1911); *Taylor* v. *Georgia*, 315 U.S. 25 (1942). Imprisonment for debt has also largely been abolished in the States. After three earlier experiments with a bankruptcy law that conditioned the debtor's discharge on creditor consent, we have rejected that device in favor or (sic) an unobstructed discharge and a "fresh start" for the debtor who honestly surrenders his existing nonexempt assets to his creditors. We would turn our backs on our history and our traditions if we were now to enact a mass peonage statute whereby the debtor's discharge and his "fresh start" are to be delayed for a five-year period of bondage during which the debtor and the debtor's family are to be pinned at the poverty level while his or her future earnings are sequestered for benefit of existing creditors.
>
> (2) The current proposals discriminate against individual, noncorporate debtors. No similar provision is made requiring the owners of corporations to continue them in operation for a five-year period in an attempt to provide enough income during that period to pay or reduce existing corporate debts. The individual debtor needs his discharge and if conditions are imposed on his receiving it, he must perforce attempt to meet the terms of those conditions in order to get it. But stockholders can walk away from a bankrupt corporate shell without fear of unpaid corporate debts for which they were never personally liable. As someone before me once said, a certificate of incorporation is, for the stockholders, a bankruptcy discharge in advance. In recognition of that fact, the Bankruptcy Code makes no provisions for discharge of corporate debtors in Chapter 7 cases. See 11 U.S.C. § 727(a)(1).
>
> (3) Voluntary composition and extension agreements have been successfully employed as a common law device, under an 1874 amendment to the Bankruptcy Act of 1867, under § 12 of the Bankruptcy Act of 1898, under Chapter XIII of the Chandler Act of 1983, and under present Chapter 13 of the Bankruptcy Code. But an involuntary composition or extension agreement forced upon a debtor seeking relief under Chapter 7 can be expected to work about

voluntary petition in bankruptcy was filed against him by friendly creditors. Upon adjudication as a bankrupt he was released from prison in 1801. He lingered on in poverty and obscurity, living in a simple Philadelphia home on an annuity provided to his wife by a friend and another signer of the Constitution, Gouverneur Morris. Robert Morris died in 1806 at the age of 73. Several colleges in Illinois and a number of other institutions are named after him.

The Act of 1841 by its terms did not take effect until February 3, 1842. It was repealed on March 3, 1843, so the Act was in effect only 13 months. Nevertheless, during this short period 33,729 persons owing nearly $441,000,000 took advantage of the Act. The law firm of Abraham Lincoln and Judge Stephen T. Logan filed 77 of these cases in the U.S. District Court at Springfield, Illinois.

as well as compulsory marriage counseling for a spouse bent on separation or divorce.

(4) With individual debtors before them in individual cases, the bankruptcy judges, who are supposed to determine whether the debtor can "pay a reasonable proportion of his debts out of anticipated future income," will get no comfort from the Johnson and credit union studies. They will have to fix the living standards and predict future income for every debtor who files under Chapter 7 if a motion is made to dismiss the case by a party in interest. In effect, they will have to make at this early stage of the case, the feasibility determination that they now make at a later stage under 11 U.S.C. § 1325(a)(6) in confirming a Chapter 13 plan. I don't see how they can begin to make that determination without requiring the Chapter 7 debtor to provide all of the information now required by the elaborate Chapter 13 statement (Official Form No. 13–5) of all Chapter 13 debtors. This will mean, for most debtors filing under Chapter 7, more expensive counsel fees even though they ultimately survive the "threshold test" and are allowed to remain under Chapter 7.

Chapter 13 (then Chapter XIII) was included in the Bankruptcy Act in 1938 as part of the overall debtor reorganization provisions of the bankruptcy law. These provisions were rewrites of debtor relief provisions that Congress had hastily adopted in 1933 to deal with debtor-creditor problems which had arisen during the Great Depression. One of these provisions, which on March 3, 1933 was added as section 74 of the Bankruptcy Act, authorized any natural person to file a voluntary petition stating he is insolvent or unable to meet his debts as they mature, and that he desires to effect a composition or an extension of time to pay his debts. This provision, which was used extensively in Birmingham, Atlanta, Knoxville, and Norfolk, and in Chicago, between 1933 and 1938, was the forerunner of chapter 13.

The hearings that were conducted at the time Chapter XIII was adopted make clear the proceeding was to be entirely voluntary and that plans were to be of relatively short duration. Congress also thought it important to allow secured claims to the extent of the value of collateral securing claims and to protect cosigners on consumer debts. One of the strong proponents of this legislation was Congressman Sam Hobbs (Judge Hobbs as he was known) of Anniston, Alabama, a member of the House Judiciary Committee. Here are some comments excerpted from statements and testimony before a subcommittee of the House Judiciary Committee on H.R. 8046, 75th Cong., 1st Sess. (1937) and a subcommittee of the Committee on the Judiciary, United States Senate on H.R. 8046, 75th Cong., 2d Sess. (1938).

> Congressman Hobbs: I would like to amend this bill, if it were legal to do so, by putting in a provision making it a capital offense for any of you retailers to seduce these people into installment purchasing beyond their means. . . .[22]

The original legislation proceeded on the assumption that extenders of consumer credit shared much of the blame for the predicament of debtors who couldn't meet their obligations; the present legislation appears to exonerate the consumer credit industry and to place the blame entirely on debtors.

> Referee Nesbit: Unless you protect endorsers and comakers, who are his friends from suit by creditors, you might just as well drop the entire matter, because such a debtor will never come into court when he knows when he files his petition they are going to sue his comakers and endorsers and call them immediately, because those comakers and endorsers are friends of his, and they are going to make it pretty hot for him and he knows it. You increase bankruptcy cases instead of decreasing bankruptcy cases. . . .[23]

Unfortunately, Section 133 of the bill presently under consideration further weakens the codebtor stay protections provided by the Bankruptcy Reform Act of 1978, and probably will, as predicted by Referee Nesbit, increase bankruptcies as the codebtors themselves are forced to file.

> Referee Adams: I think we have something that was not in the others. We have added a provision that, if a man has not worked out his debt at the end of a 3-year period after his plan has gone into effect, he shall be discharged from those debts. *We do not want to make wage slaves out of these men*, we do not want them bound for life when they are under this plan, because it might possibly go on for as much as 15 years or longer.[24] (Underscoring added.)

[22] Hearings before House Judiciary subcommittee on H.R. 8046, at 63 (1937).
[23] Hearings before House Judiciary subcommittee on H.R. 8046, at 254 (1937).
[24] Hearings before House Judiciary subcommittee on H.R. 8046, at 53 (1937).

Under present law the plan period is three years unless the debtor voluntarily, for cause shown, is permitted to extend the plan for five years.

Under Section 606 of H.R. 833 some debtors can be forced involuntarily into a plan that will extend for five years. Debtors will be forced into wage slavery which is completely contrary to the original concept of Chapter XIII adopted by this subcommittee in 1938.

Congress has in the past considered and rejected proposals for compulsory chapter 13 proceedings.

In 1965 Senator Albert Gore, Sr., the father of Vice President Gore, was concerned because for the year ended June 30, 1965 there were 9,002 employee bankruptcy cases filed in the bankruptcy courts serving Tennessee. Congressman Richard A. Poff of Virginia was "alarmed" by the fact there were 4,491 such cases filed in Virginia, and there might have been more except for the fact that government employees residing in Virginia at that time were protected from garnishment by federal law.

By way of contrast, during the year ended June 30, 1965 there were only 124 employee bankruptcy cases filed in North Carolina and only 140 such cases filed in South Carolina. Instead of focusing on what North Carolina and South Carolina were doing right and Tennessee and Virginia were doing wrong, Senator Gore and Congressman Poff proposed changing the federal bankruptcy laws. They both introduced compulsory chapter XIII bills.

One major reason for the high rate of bankruptcy filings in Tennessee and Virginia was rather simple. Tennessee and Virginia permitted wage garnishment. North and South Carolina did not.

In 1965 six states, California, Ohio, Illinois, Alabama, Tennessee and Michigan, with only 26% of the U.S. population, accounted for 53% of the nonbusiness bankruptcy cases filed that year. This remained largely true throughout the 1960s.

I have included a chart, based on information provided by the Administrative Office of the United States Courts, which ranks the states in order by the number of individual bankruptcy filings per 1,000 households in the state. This exhibit reveals that individual bankruptcy filings per 1,000 households are relatively low in states such as Pennsylvania, which do not permit wage garnishment except for limited purposes such as for the collection of alimony, maintenance and support, and taxes. Not surprisingly, today individual bankruptcy filings remain high in Tennessee and low in North Carolina and South Carolina.

This should tell us the number of individual bankruptcy filings could be reduced dramatically, perhaps cut in half, simply by eliminating wage garnishment for the collection of consumer debts. In addition to Pennsylvania and the Carolinas, New Hampshire, Vermont and Texas have no wage garnishment. New York permits only 10% of disposable earnings to be sequestered by garnishment. The South Carolina legislature has been debating whether to institute wage garnishment. If it does, in all likelihood individual bankruptcy filings in that state will surge; more bankruptcy judges will be required to administer the law and more facilities for the bankruptcy courts will be required. In other words, some of the costs of such a change in state law may be passed on to the Federal Government.

In 1968, in enacting restrictions on wage garnishment as part of the Consumer Credit Protection Act, Congress found that unrestricted garnishment of compensation due for personal services encourages the making of predatory extensions of credit.[25] Federal law permits sequestration of only 25% of a debtor's disposable income by garnishment other than a garnishment for support of a spouse or dependent child.[26] Many states such as Kentucky provide for "continuing" garnishment, that is, the garnishment remains in effect until the judgment of which the garnishment issued is satisfied. Such a law favors the swift because once a garnishment is obtained other creditors cannot benefit from garnishment until the judgment on which the first garnishment is issued is paid. Thus, it is difficult to conclude that garnishment benefits creditors generally, and, because garnishment often triggers bankruptcy, the end result may be that the persistent creditor causes loss to all other creditors.

If, as Congress has found, unrestricted garnishment encourages predatory extensions of credit, it seems obvious that compulsory chapter 13 will produce the same result. If there is no way out for debtors, predatory extensions of credit will become more commonplace and predatory lenders will undermine the soundness of our credit system. If VISA and MasterCard succeed in Congress with this legislation, their next stop will be state legislation where their game plan will be enactment of harsh-

[25] See 15 U.S.C. § 1671.
[26] 15 U.S.C. § 1673.

er collection laws. They will probably target Pennsylvania for repeal of restrictions on garnishment.

At present, the bankruptcy law is about the only law that gives lenders pause in the extension of credit, which is as it should be. Compulsory chapter 13 legislation, if enacted into law, may encourage lenders to throw caution to the wind.

Many lenders now engage in what conservative Senator Lauch Faircloth has described as "precarious, reckless, bordering on sleazebag lending."[27]

States are now permitting various forms of sleazebag lending at exorbitant interest rates that are triggering resort by debtors to relief under the Bankruptcy Code. For example, so-called check cashers (they call themselves delayed deposit lenders) will hold a check for two weeks for a fee of $15.00 per hundred dollars. If the debtor doesn't redeem the check in two weeks another $15.00 is due. This $15.00 roll-over charge may go on indefinitely because this charge translates into a 390% annual interest rate. If the debtor doesn't pay, the lenders may swear out a warrant for submitting an insufficient funds check. Testimony in some of my cases indicate these lenders not only threaten debtors with arrest and criminal prosecution, but also threaten to have their children taken away from them by the state social services agency. We have more than 100 bankruptcy cases in the Eastern District of Kentucky filed by debtors to forestall collection harassment by check cashing agencies. These agencies operate in a large number of states.

There are other lenders and sellers who likewise prey on the poor. For example, so-called auto title loan lenders, with only a pawn shop license, are making title loans on automobiles allegedly taken in pawn. Debtors deposit the certificate of title and a set of keys to the car with the lender. Debtors pay a pawn fee of about $40, which is due each 30 days to renew the pawn, at which time they also must pay accrued interest of $200 per month for each $1,000 borrowed. The interest can be even higher than 390% annually.

Then there are the rent-to-own stores that allegedly rent, but in actuality sell furniture, TV sets and appliances to debtors at prices three or four times higher than the amount for which such items can be purchased at regular appliance or furniture stores. The quadruple pricing of such items is a hidden exorbitant interest rate.

Congress should also be aware of the fact that banking institutions which are complaining of the number of bankruptcies are extending credit to fund these sleazebag lending operations, and, in some instances, as a result of acquisitions and mergers may own subsidiaries that engage in such sleazebag lending.[28]

If the purpose of legislation is to reduce individual bankruptcy filings, the focus of study to achieve this objective should be on state laws that seem to trigger bankruptcy. It is the legal environment of debtors in states with high rates of bankruptcy that needs to be studied and ameliorated by federal law. Tightening the bankruptcy laws will only give aid and comfort to these predatory lenders, and ultimately may cause debtors to escape by catching the bus out of town and hiding from creditors in much the same manner as ex-husbands disappear to avoid paying alimony and support.

Presently about one-third (more than 30%) of the 1.4 million debtors seeking relief under the Bankruptcy Code voluntarily opt for relief under chapter 13. According to the U.S. Trustee's office, creditors are presently being paid approximately $2 billion annually in these chapter 13 cases. This occurs because chapter 13 is an attractive alternative form of relief for debtors. Codebtors on consumer debts are protected. Secured claims, except claims secured only by real estate that is the debtor's principal residence, can be allowed to the extent of the value of the collateral securing the claim. Liens can be ordered released when the allowed amount of a secured claim, plus accrued interest, is paid. The debtor receives a discharge from some debts that might otherwise be nondischargeable in a chapter 7 case.

These attractive features of chapter 13 are removed in this bill. Consequently, there will be few, if any, voluntary chapter 13 cases. This means that the number of coerced chapter 13 cases are likely to be less under this legislation than voluntary chapter 13's under present law. Instead of a return of $2 billion to creditors, the return will be significantly less. Most debtors will opt to surrender collateral rather than pay creditors holding secured claims far more than the collateral is worth, as they would be forced to do under H.R. 833.

In 1982 Robert Johnson, Blair Shick, and Richard Peterson for the Credit Research Center conducted a study when the Center was located at Purdue University.

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[27] *National Mortgage News*, November 3, 1997, 1997 WL 12863625.

[28] See *Real Estate Finance Today*, Electronic Edition, January 2, 1998, at 2; "[Bank] Sitting on Gain From B&C Stock," *National Mortgage News*, August 4, 1997; "Subprime Boom Makes Partners of Traditional Foes," *American Banker*, October 2, 1997; *Asset Sales Report*, August 11, 1997, at 1.

This earlier Credit Research Center study, which Professor Vern Countryman found to be flawed in several respects,[29] appears nevertheless somewhat more honest than the current October 7, 1997 study on which the proponents and sponsors of H.R. 833 are now relying. For example the earlier study reported that 32% of the debtors surveyed gave as an "important" reason for filing bankruptcy that "credit was too easy to get." Also the Johnson study acknowledged that only about a quarter (') of the debts owed by debtors at the time of filing would be recoverable in the absence of bankruptcy. In other words, only about one-fourth of losses suffered by creditors can legitimately be attributed to bankruptcy.[30]

Both the CBO and the GAO have cautioned that the most recent Credit Research Center study is based on numerous unproven assumptions.[31]

Probably the most glaring defect in the study is the fact that automobile debt and other secured debt is lumped with unsecured debt in the "non-housing debt" category to arrive at the conclusion that 25% of chapter 7 debtors could repay at least 30 percent of their non-housing debt over 5 years, while still maintaining their normal housing payments and other living expenses.

The defect in this calculation is glaringly obvious. Debtors cannot pay 30% of automobile debt and keep the collateral securing the debt. Debtors typically reaffirm automobile debt and other debts secured by collateral which they wish to retain. Thus, they reobligate themselves to repay far more than 30% of these debts and once so reobligated, they seldom have money to pay on general unsecured debts. The amount available for payment on unsecured debts most often will be an insignificant percent.

This is confirmed by Sections 124 and 125 of H.R. 833 which amends section 506 of the Bankruptcy Code to require individual debtors in cases under chapter 7, 11, 12, or 13 to pay the balance due on secured debt plus accrued interest, plus interest at the contract rate in order to retain an automobile or other personal property purchased, within 5 years of bankruptcy. This provision in the bill completely undercuts the Credit Research Center study which implies this legislation will require repayment of 30% of unsecured debt. Obviously that is not so.

As suggested, the amount of repayment on unsecured debt is likely to be insignificant.

This is verified by a study conducted by Professors Marianne B. Culhane and Michaela M. White of Creighton University School of Law. They concluded that only 3% of their sample of over 1,000 debtors had sufficient repayment capacity to be barred from relief under chapter 7.

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[29] Please refer to Part III of my statement.

[30] See *Consumers Right to Bankruptcy: Origins and Effects*, Monograph No. 23 Credit Research Center, Kannert Graduate School, Purdue University, 1982.

[31] There is a wealth of literature about the unreliability and bias of industry-funded research. I will give you an example of the bias of industry-funded research with which I am quite familiar. In Lexington, Kentucky, the Tobacco and Health Research Institute and the University of Kentucky Medical School are located within 100 yards of each other. Both came into existence in the late 1950s. The doctors at the medical school have had no difficulty concluding that smoking tobacco is injurious to one's health. The researchers at the Tobacco Health and Research Institute, which is funded by the tobacco industry, have been unable to reach this conclusion. Approximately 15 years ago a researcher for the Institute presented a preliminary study which indicated cigarette smoke was harmful to a smoker's eyes. He asked for additional funds to expand and confirm his study. He was denied additional funding, was branded as disloyal, and was fired. More recently another researcher obtained patents on two devices that facilitate the absorption of drugs that help people stop smoking. He too was fired. Industry-funded research must further the goals of the industry, otherwise the researcher's tenure may be tenuous.

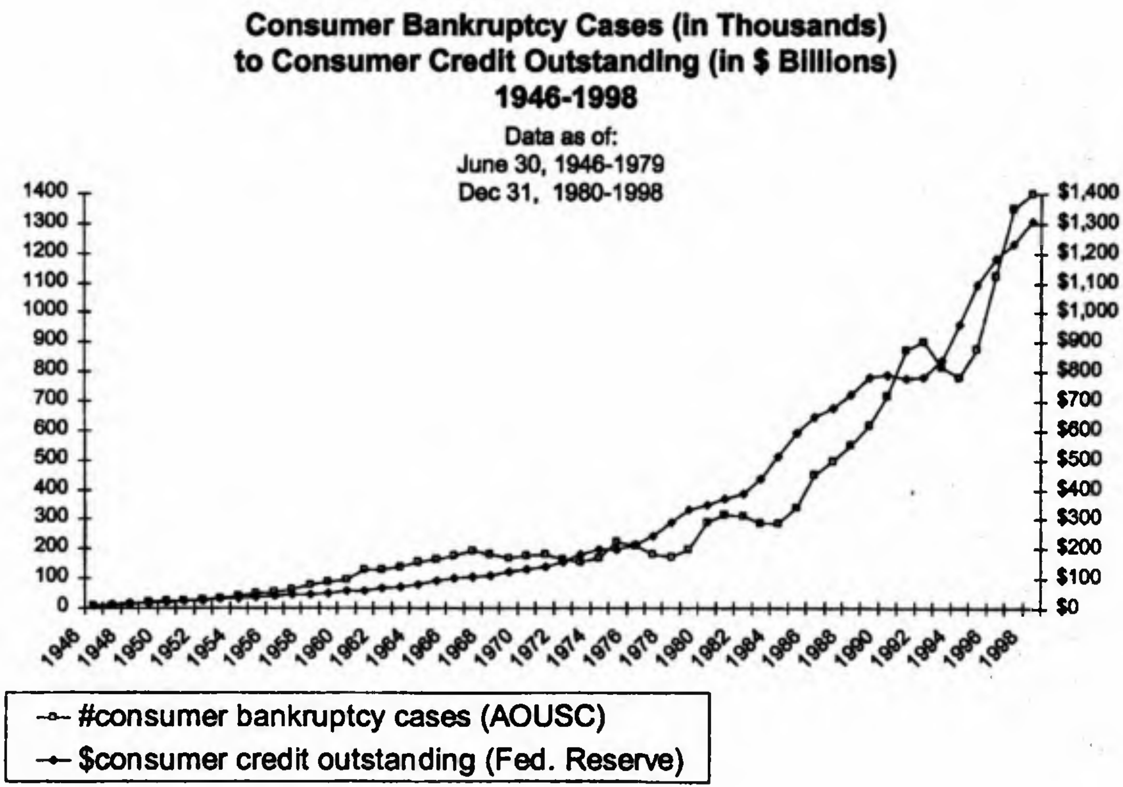

Consumer Bankruptcy Cases (in Thousands)
to Consumer Credit Outstanding (in $ Billions)
1946-1998
Data as of:
June 30, 1946-1979
Dec 31, 1980-1998
1400
1300
1200
1100
1000
900
800
700
600
500
400
300
200
100
0
$1,400
$1,300
$1,200
$1,100
$1,000
$900
$800
$700
$600
$500
$400
$300
$200
$100
$0
1946
1948
1950
1952
1954
1956
1958
1960
1962
1964
1966
1968
1970
1972
1974
1976
1978
1980
1982
1984
1986
1988
1990
1992
1994
1996
1998
#consumer bankruptcy cases (AOUSC)
$consumer credit outstanding (Fed. Reserve)

CHART 1

Consumer Bankruptcy Cases (In Thousands)
To Consumer Credit Outstanding As Adjusted
To Include Substitution Of Home Equity Debt (In $ Billions)
1946-1998

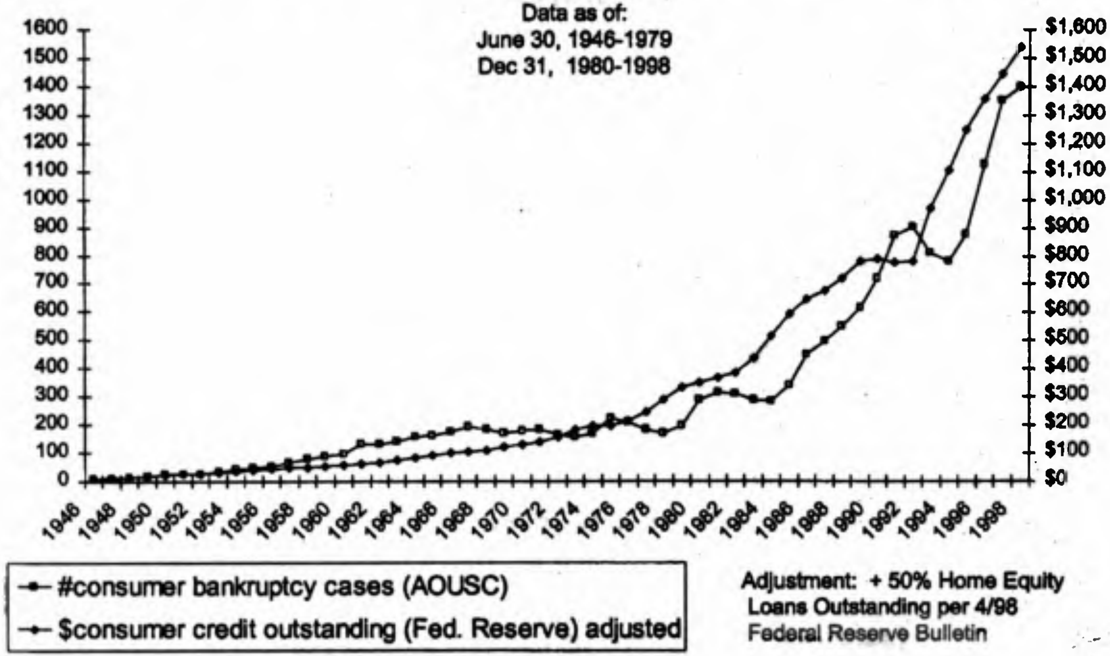


CHART 2

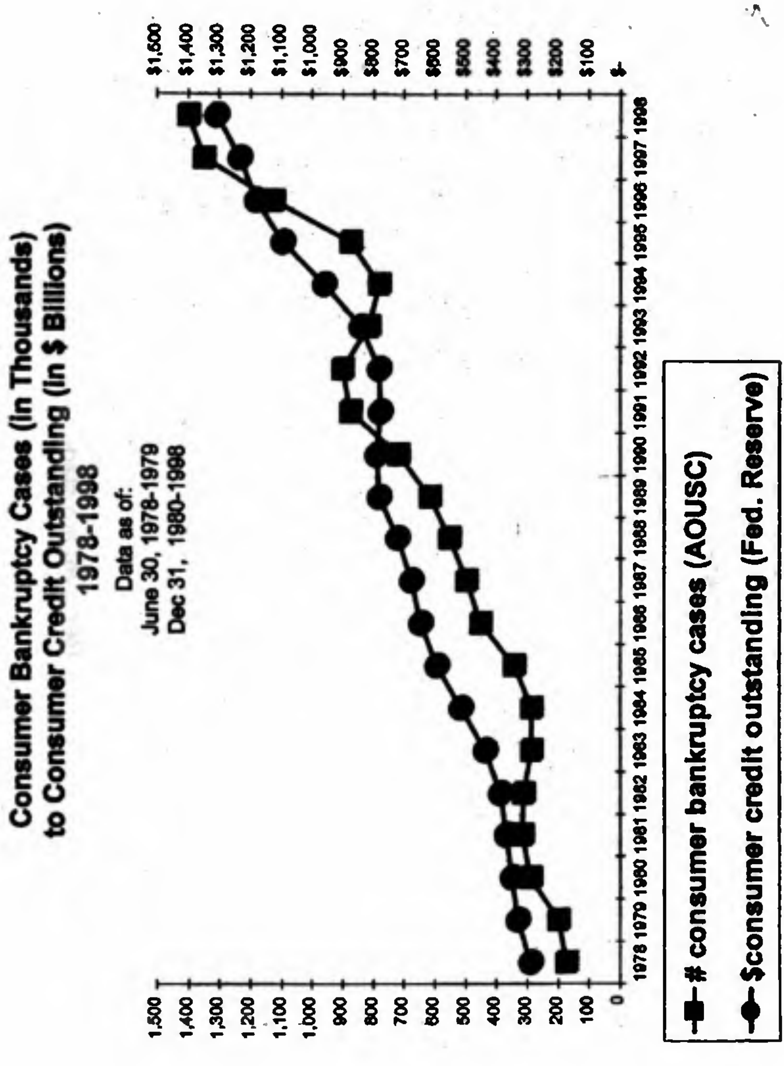

Consumer Bankruptcy Cases (In Thousands)
to Consumer Credit Outstanding (In $ Billions)
1978-1998
Data as of:
June 30, 1978-1979
Dec 31, 1980-1998
1,500
1,400
1,300
1,200
1,100
1,000
900
800
700
600
500
400
300
200
100
0
$1,500
$1,400
$1,300
$1,200
$1,100
$1,000
$900
$800
$700
$600
$500
$400
$300
$200
$100
$-
1978 1979 1980 1981 1982 1983 1984 1985 1986 1987 1988 1989 1990 1991 1992 1993 1994 1995 1996 1997 1998
consumer bankruptcy cases (AOUSC)
$consumer credit outstanding (Fed. Reserve)

CHART 3

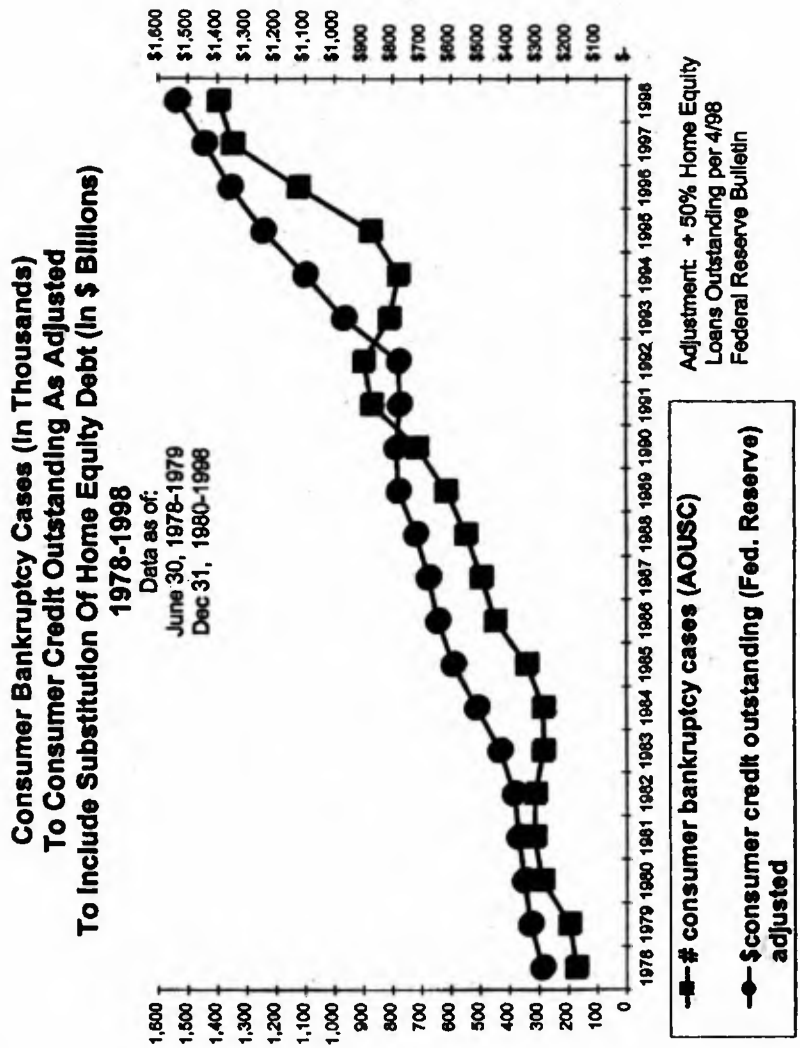

Consumer Bankruptcy Cases (In Thousands)
To Consumer Credit Outstanding As Adjusted
To Include Substitution Of Home Equity Debt (In $ Billions)
1978-1998
Data as of:
June 30, 1978-1979
Dec 31, 1980-1998
1,600 1,500 1,400 1,300 1,200 1,100 1,000 900 800 700 600 500 400 300 200 100 0
$1,600 $1,500 $1,400 $1,300 $1,200 $1,100 $1,000 $900 $800 $700 $600 $500 $400 $300 $200 $100 $-
1978 1979 1980 1981 1982 1983 1984 1985 1986 1987 1988 1989 1990 1991 1992 1993 1994 1995 1996 1997 1998
consumer bankruptcy cases (AOUSC)
$consumer credit outstanding (Fed. Reserve) adjusted
Adjustment: + 50% Home Equity
Loans Outstanding per 4/98
Federal Reserve Bulletin

CHART 4

Consumer Bankruptcy Cases to Credit Card Debt 1993 - 1998

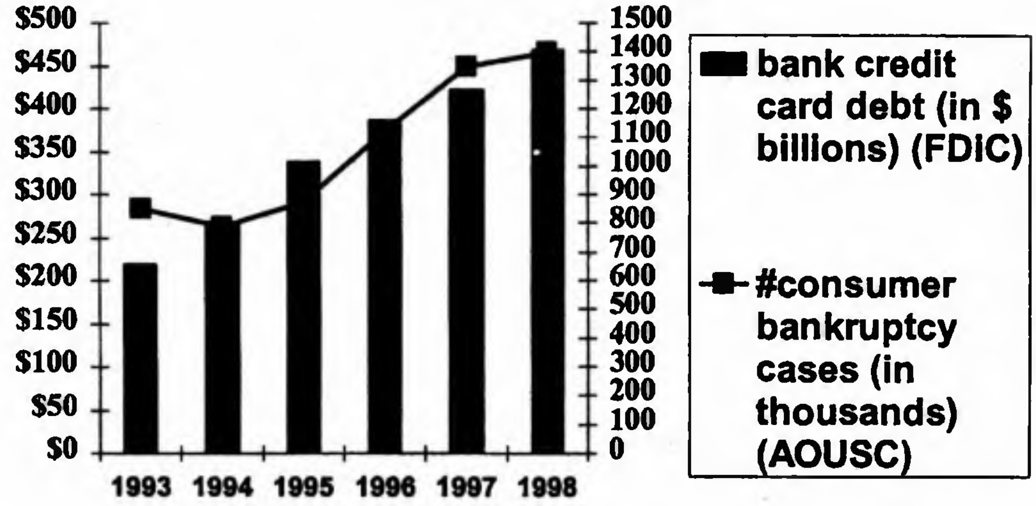


CHART 5

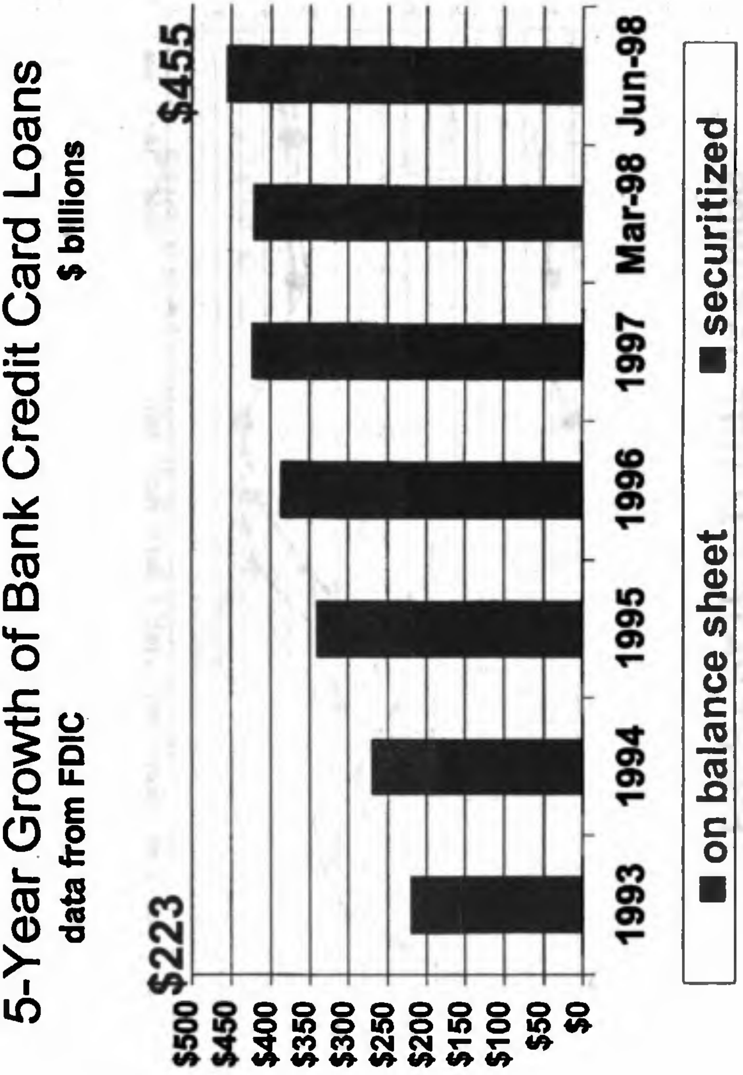
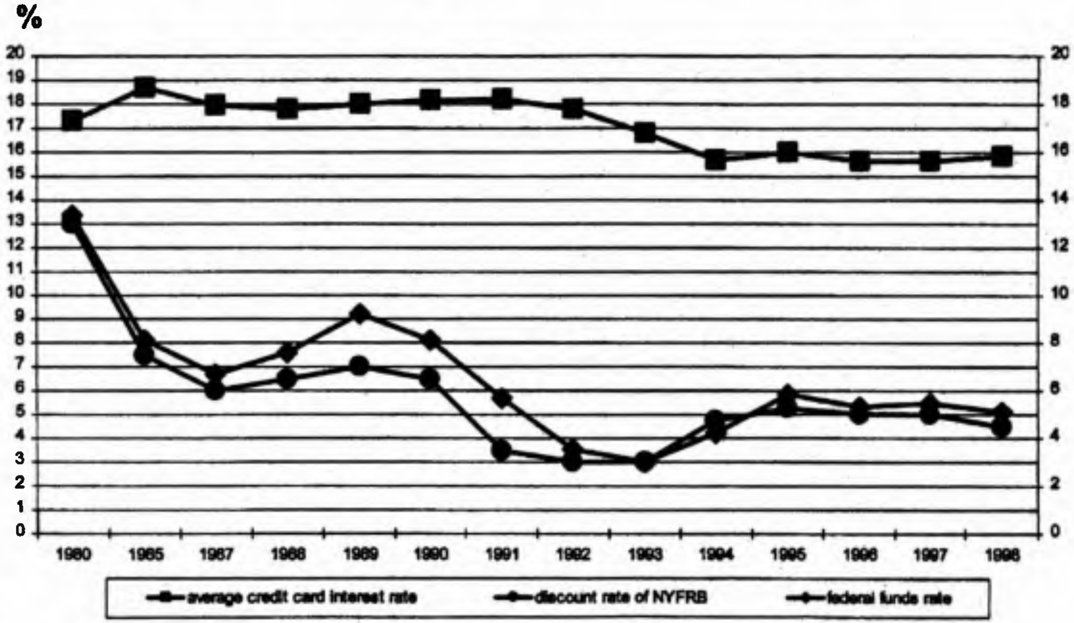

5-Year Growth of Bank Credit Card Loans
data from FDIC
$ billions
$223
$455
$500
$450
$400
$350
$300
$250
$200
$150
$100
$50
$0
1993
1994
1995
1996
1997
Mar-98
Jun-98
on balance sheet
securitized

CHART 6

COMPARISON OF AVERAGE CREDIT CARD INTEREST RATE TO COST OF FUNDS

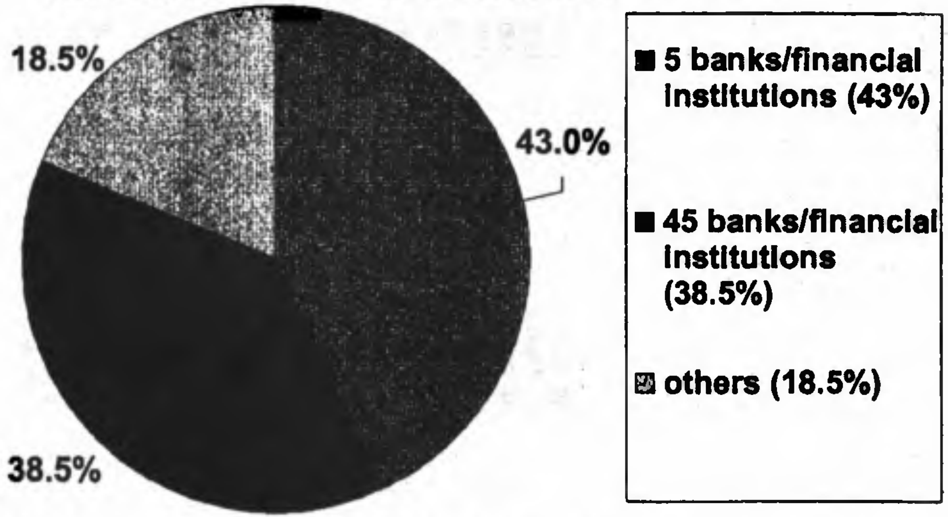


"average credit card interest rate" includes introductory or "teaser" rates

Source: Federal Reserve

CHART 7

More Than 80% Of All Credit Card Debt (In Dollars) Is In The Hands Of Only 50 Banks And Financial Institutions:



"Top 50 Companies in Managed Bank Credit Card Loans," American Banker at 10-11 (Sept. 22, 1998)

CHART 8

BANKRUPTCY FILINGS BY STATE PER 1,000 HOUSEHOLDS

1997

1. Tennessee	25.58
2. Georgia	22.65
3. Nevada	20.99
4. Alabama	20.85
5. Mississippi	19.55
6. California	18.75
7. Utah	18.56
8. Oklahoma	17.75
9. Virginia	16.94
10. Indiana	16.55
11. Arkansas	16.32
12. Idaho	15.81
13. Washington	15.28
14. New Jersey	14.66
15. Louisiana	14.65
16. Illinois	14.65
17. Rhode Island	14.57
18. Kentucky	14.56
19. Arizona	14.49
20. Oregon	14.33
21. Kansas	13.31
22. Florida	12.87
23. Missouri	12.67
24. Ohio	12.59
25. Colorado	12.41
26. New Mexico	11.96
27. West Virginia	11.92
28. Minnesota	11.38
29. Hawaii	11.36
30. New Hampshire	11.12
31. District of Columbia	11.12
32. New York	11.09
33. Michigan	11.05
34. Connecticut	11.03
35. Wyoming	10.90
36. Texas	10.37
37. Montana	10.30
38. Massachusetts	10.28
39. Wisconsin	9.81
40. Delaware	9.49
41. Nebraska	9.39
42. Pennsylvania	9.35
43. North Carolina	9.26
44. Iowa	8.90
45. Maine	8.74
46. South Dakota	8.60
47. Vermont	8.38
48. South Carolina	8.10
49. North Dakota	7.94
50. Alaska	6.29

Bankruptcy Filings by State per 1,000 Households, 1991–1997

State	1991	1992	1993	1994	1995	1996	1997
Alabama	18.67	17.24	15.42	14.89	16.64	19.50	20.85
Alaska	5.48	5.14	4.50	4.30	4.50	5.72	6.29
Arizona	14.36	14.13	12.03	10.12	9.86	12.02	14.49
Arkansas	9.25	9.07	7.61	7.39	9.99	13.88	16.32
California	13.23	15.06	14.47	13.20	13.44	16.54	18.75
Colorado	13.07	11.93	10.00	9.04	9.35	10.92	12.41
Connecticut	6.41	7.68	7.39	6.89	7.46	9.19	11.03
Delaware	4.81	6.22	5.70	4.68	6.21	7.42	9.49
District of Columbia	5.53	5.88	5.29	5.85	6.44	8.43	11.12
Florida	9.38	9.74	7.94	7.79	8.27	10.51	12.87
Georgia	21.21	18.43	16.13	15.91	17.36	20.33	22.65
Hawaii	3.01	3.83	3.98	4.21	5.30	7.96	11.36
Idaho	11.20	10.70	9.28	8.33	9.84	12.63	15.81
Illinois	10.08	10.04	9.25	8.83	9.90	12.52	14.65
Indiana	13.33	12.81	10.76	10.08	10.78	13.53	16.55
Iowa	5.81	5.78	4.99	5.05	6.03	7.90	8.90
Kansas	10.24	9.45	8.29	8.20	9.39	11.52	13.31
Kentucky	11.13	10.21	8.45	8.35	9.87	12.72	14.56
Louisiana	9.10	9.19	8.16	8.12	9.45	13.00	14.65
Maine	4.90	4.70	3.97	3.70	4.59	6.36	8.74
Maryland	8.27	9.30	8.69	8.38	9.67	13.01	16.95
Massachusetts	6.44	7.58	6.74	6.25	6.49	7.64	10.28
Michigan	7.36	7.73	6.78	6.30	6.97	8.89	11.05
Minnesota	10.55	9.93	8.65	7.99	8.53	10.34	11.38
Mississippi	13.83	13.00	11.00	10.43	12.26	16.08	19.55
Missouri	9.48	9.30	7.53	7.33	8.25	10.77	12.67
Montana	6.85	6.43	5.86	5.80	6.86	8.23	10.30
Nebraska	7.51	6.89	6.02	5.64	6.07	8.40	9.39
Nevada	14.65	15.55	14.81	12.75	13.39	17.01	20.99
New Hampshire	9.40	9.21	8.65	7.22	7.45	8.42	11.12
New Jersey	7.94	8.93	8.56	8.34	9.70	11.80	14.66
New Mexico	8.04	7.99	6.66	5.93	7.14	9.48	11.96
New York	6.86	7.77	7.42	7.06	7.65	9.23	11.09
North Carolina	6.60	5.76	4.93	4.99	5.82	7.94	9.26
North Oakota	5.19	5.20	4.55	4.85	5.36	6.84	7.94
Ohio	10.81	9.95	8.31	7.61	8.15	10.45	12.59
Oklahoma	12.86	11.85	10.88	10.47	11.22	14.59	17.75
Oregon	12.56	12.07	10.92	10.59	11.53	13.37	14.33
Pennsylvania	5.01	5.44	4.69	4.47	5.34	7.08	9.35
Rhode Island	9.05	9.75	8.72	7.98	8.87	11.46	14.57
South Carolina	5.80	5.57	4.88	4.90	5.52	7.10	8.10
South Oakota	5.91	5.57	5.30	4.56	5.37	7.00	8.60
Tennessee	22.65	20.70	19.05	17.82	19.35	23.89	25.58
Texas	7.68	7.96	6.79	6.34	7.17	8.92	10.37
Utah	14.92	14.35	11.72	10.98	11.80	14.54	18.56
Vermont	4.47	4.61	3.86	3.77	4.73	6.04	8.38
Virginia	12.08	11.94	10.54	9.83	11.42	14.32	16.94
Washington	9.48	9.55	8.58	8.56	10.08	13.38	15.28

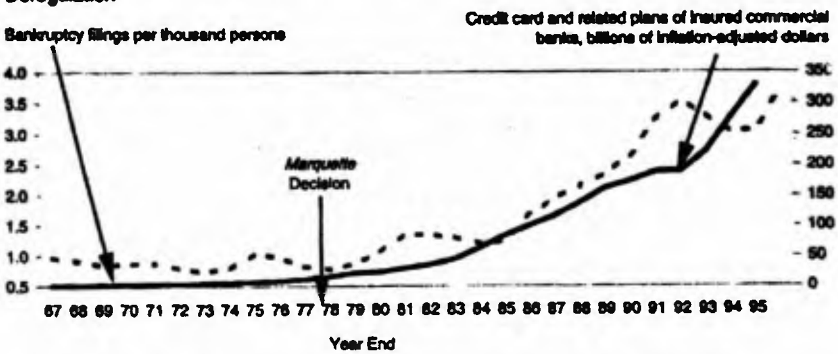
Bankruptcy Filings by State per 1,000 Households, 1991–1997—Continued

State	1991	1992	1993	1994	1995	1996	1997
West Virginia	6.13	6.42	5.14	5.21	5.92	8.42	11.92
Wisconsin	6.84	6.45	5.68	5.68	6.62	8.31	9.81
Wyoming	9.01	7.71	6.84	6.61	6.82	9.71	10.90

Bankruptcy filings are for 12-month periods ending 12/31. Households are mid-year estimates provided by the Bureau of the Census, except for 1997 which was estimated by the Bankruptcy Judges Division of the Administrative Office of the United States Courts.

Bank Trends—The Effect of Consumer Interest Rate Deregulation on Credit Card Volumes, Charge-Offs, and the Personal Bankruptcy Rate

The Long-Term Rise in the Personal Bankruptcy Rate Started Shortly after Interest Rate Deregulation



Source: Bank call reports, Administrative Office of the U.S. Courts, and Census Bureau

The rising level of credit card debt is often cited as one of the factors in the rising U.S. personal bankruptcy rate. Numerous theories have been advanced to explain the increases, including aggressive marketing by credit card issuers and a lack of discipline on the part of consumers. These explanations do not address the underlying reason for these trends. This paper argues that a 1978 Supreme Court decision ("Marquette") fundamentally altered the market for credit card loans in a way that significantly expanded the availability of credit and increased the average risk profile of borrowers. Marquette ushered in deregulation of usury ceilings on consumer interest rates by allowing lenders in a state with liberal usury ceilings to export those rates to consumers residing in states with more restrictive usury ceilings. The result was a substantial expansion in credit card availability, a reduction in average credit quality, and a secular increase in personal bankruptcies. The Canadian experience with bankruptcies supports this argument. This paper contends that a tightly regulated world, marked by restricted access to consumer credit and a low level of personal bankruptcies, was exchanged for a deregulated world, marked by expanded access to consumer credit and a higher level of personal bankruptcies. This argument implies that a return to the bankruptcy rates and charge-off levels that prevailed in the early 1980s or before may be unlikely.

The author acknowledges the valuable contribution of the participants who provided feedback on this paper in a February 13, 1997, roundtable discussion. The author acknowledges the valuable contribution of Alicia Amiel, FDIC librarian, who provided research assistance. The author also acknowledges the valuable contribution of Jerilyn Rogin, FDIC senior attorney, who provided information on Canada's Interest Rate Act.

THE EFFECT OF CONSUMER INTEREST RATE DEREGULATION ON CREDIT CARD VOLUMES, CHARGE-OFFS, AND THE PERSONAL BANKRUPTCY RATE

Introduction

The U.S. personal bankruptcy rate has risen to a historically high level, from less than one per thousand population annually in the early 1970s to almost five per thousand population for the year ending September 30, 1997. An increase in outstanding consumer debt, particularly credit card debt, has been cited as a significant contributor to the increased rate of filing. One financial planner was recently quoted as saying, "I've never seen anyone come in with a financial problem that wasn't related to credit cards." [1]

Aggressive marketing by credit card lenders or a lack of discipline on the part of consumers often are blamed for the increase in credit card debt outstanding. These explanations in essence argue that behavior has changed: that lenders have become more aggressive or borrowers less prudent. Whatever the merit of these explanations, they leave unanswered questions as to when and why behavior changed.

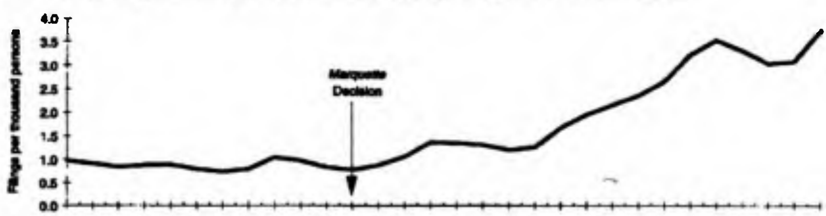
Some industry experts have attributed the increases in credit card debt outstanding and personal bankruptcies to changes in marketplace rules rather than changes in lender or borrower behavior. One type of change to the marketplace rules occurred in both 1978 and 1994 when federal bankruptcy law was modified, in part, to increase the level of assets that could be protected in a bankruptcy filing.[2]

These legal changes, which made bankruptcy a more attractive option for debtors, sometimes are cited as reasons for the rising level of personal bankruptcies. Despite the intuitive appeal of this argument, there is some evidence that changes in bankruptcy laws may not be a primary driver of increases in personal bankruptcy rates. For example, Ellis (1998) provides evidence on the lack of correlation between state homestead exemption rates and state personal bankruptcy rates. Zandi (1997) points out that a similar increase in personal bankruptcies has occurred in Canada without any significant recent changes in the bankruptcy law.

Another significant change to the marketplace rules occurred in the late 1970s with deregulation of consumer interest rates. Both Ausubel (1997) and Rougeau (1996) focus on interest rate deregulation as the event that set the United States on a course of rising credit card volumes. Chart 1 illustrates that the dramatic rise in personal bankruptcies did indeed begin shortly after the Supreme Court's Marquette decision, which initiated interest rate deregulation. This chart suggests a relationship between interest rate deregulation and the increase in personal bankruptcies. The evidence alone is not sufficient to establish a causal relationship; this paper argues that such a relationship exists.

Chart 1

The Long-Term Rise in Personal Bankruptcy Filings Started Shortly after Interest Rate Deregulation



Source: Administrative Office of the U.S. Courts, Census Bureau

The argument advanced in this paper for the importance of interest rate deregulation as a driver of expanded credit availability and higher personal bankruptcy rates differs from those offered by Ausubel and Rougeau. Ausubel (1997) maintains that borrowers underestimate their use of credit cards and, therefore, the importance of credit card interest rates, which enables lenders to earn an extranormal profit on every good customer. He argues that the extraordinary profits made by credit card lenders have caused them to relax their standards and make credit available to poorer credit risks. Rougeau (1996) suggests that the absence of interest rate regulation allows credit card lenders to pursue unlimited profits by taking advantage of borrowers' weakness and desire to consume, which often reaches an irrational level.

This paper does not take a position on the merits of Ausubel's and Rougeau's arguments. Instead, it offers another explanation of the impact of interest rate deregulation that is based on the pricing and underwriting decisions of lenders and the rational borrowing decisions of consumers. The argument suggests that an increase in both credit availability and bankruptcies was a perhaps inevitable result of interest rate deregulation.

Usury Laws Have a Very Long History

Usury laws perhaps have a more ancient lineage than any other form of economic regulation. Modern scholars appear to agree that limitations on lending rates at least in Western law derive from biblical prohibitions on usury.[3] During biblical times, and throughout much of recorded history, usury was defined as lending at *any* amount of interest. The prohibition of usury was based partially on the principle that charging interest is taking advantage of the debtor (Moser 1997, 3–4).

The Greek philosopher Plato also condemned charging interest because he felt that it produced an inequality of wealth and destroyed the harmony between citizens of the state (Moser 1997, 5–6). Plato's writings suggest that some members of society need to be protected from lenders, an argument that still finds its way into the modern-day debate over consumer credit.[4]

As commerce expanded and money lending became increasingly important, opinions about usury changed. The Romans were more tolerant of usury and were one of the first societies to recognize interest and set maximum legal rates for various types of loans (Mandell 1990, 13). Throughout much of recorded history, societies around the world have felt that it was important to limit the interest rate that a lender can charge in order to restrain lenders from taking advantage of borrowers.

American Usury Laws Have Been in Place since the Colonial Era

The American colonies built upon well-established English law regarding usury and after the Revolution retained this body of law (Ackerman 1981, 85). By 1886, every state had some general usury limit in place.[5] However, when states felt that the general usury limit was unduly restricting the amount of credit, they passed legislation to create exceptions. For example, almost every state has some provision permitting businesses to borrow at higher rates than the general usury limit (Ackerman 1981, 108). As the number of exceptions grew, state usury laws became a complex and disorganized array of rules.

The Development of the Credit Card Industry and the Role of Usury Laws

Charge cards came into use around 1914 when Western Union and various department stores, hotels, and oil companies began using them.[6] These early cards could be used to purchase the issuer's goods and services only, and balances had to be paid in full each month. In 1950, Diners' Club introduced the first "general-purpose" charge card that could be used at a variety of establishments; American Express issued a similar card in 1958. Credit cards evolved from charge cards when banks entered the industry as issuers in the late 1950s. Banks issued general-purpose credit cards that allowed balances to be carried over from month to month.

Even after banks entered the credit card industry, the growth of the industry was slow for more than a decade because most merchants accepted only cards issued by local banks. The modern-day credit card industry emerged in 1966 when Bank of America began licensing its BankAmericard credit card logo to other banks, and a national system to process credit card transactions began to develop. These participating banks later formed the entity known today as VISA. Another group of banks formed the MasterCard association in 1966.

State Usury Laws Restricted the Credit Card Industry

The VISA and MasterCard associations developed the infrastructure for a nationwide credit card payment system and convinced merchants nationwide to accept their cards. However, state usury laws prevented credit card lenders from reaping all the benefits of a nationwide system. First, the differences in state laws imposed a costly legal burden on credit card issuers, who were required to monitor and adhere to at least 50 different state laws. Also, lenders did not always find it profitable to lend in states where usury ceilings were low.

Lenders were bound to the individual state limits because of the way the federal banking law was interpreted at that time. Federal law subjects national banks to the rate ceilings imposed by the states.[7] This law originally was interpreted as requiring the lender to charge no more than the limit prescribed by the state where the borrower resided. State laws varied as to the maximum rates that could be charged on credit card loans as well as on whether other charges, such as membership fees and late fees, were permissible.

Usury Laws Limited the Volume of Credit Card Lending

The development of the VISA and MasterCard associations resulted in significant growth in credit card debt outstanding; however, not all consumers were granted access to credit cards. If the rate ceiling in effect was too low to enable lenders to generate sufficient income to cover the losses incurred when lending to high-risk borrowers, lenders would deny that group access to credit. Therefore, in a regime of restrictive usury ceilings, where the lenders' income potential was limited, lenders extended credit only to higher-quality borrowers, and poorer quality borrowers were shut out of the market. This situation resulted in less credit availability and lower charge-offs.

Studies by Canner and Fergus (1987) and Villegas (1989) confirm that restrictive usury ceilings reduce the overall supply of credit and that high-risk borrowers are the hardest hit by the cutback.[8] The example of Sears provides a good illustration of a lender's reaction to restrictive usury ceilings.[9] In 1974, rising interest rates caused usury limits in some states to become binding, and Sears began to cut back promotion of its retail card in those states. For example, in Arkansas, Minnesota, South Dakota, Iowa, and Washington, where interest rate limitations ranged from 9 to 12 percent, residents were allowed to receive service, but accounts were opened only on request. Delinquent customers in these states often found that their accounts were closed permanently.

The Dismantling of Consumer Usury Laws

Economic Forces in the 1970s Made Credit Card Lending Unprofitable

High inflation and high interest rates in the late 1970s made state usury limits more restrictive. As a result, credit card issuers experienced declining earnings and even suffered losses. A General Accounting Office (1994) report on the credit card industry shows that the average pretax earnings of VISA and MasterCard issuers was over 4 percent of outstanding balances in 1977 but fell for four consecutive years to less than negative 1 percent in 1980 and 1981. The interest rate ceilings set by many states simply were too low to make credit card lending profitable in the high-interest-rate environment.

Usury ceilings varied widely throughout the United States, but at the end of the 1970s, 37 states had some kind of interest rate ceiling on credit cards.[10] Only three states had no limit, and two states had limits that were above 18 percent. Three states allowed rates of above 18 percent for a portion of the balance, while the remainder of the states set rates lower. Minnesota had the lowest interest ceiling in the country, at 8 percent.

The Supreme Court Deregulated Consumer Interest Rates

In the economic environment of the late 1970s, the general opinion on usury limits appeared to change.[11] Part of this relaxation can be attributed to the high nominal interest rates of the time, which restricted credit availability and made the disadvantages of usury limits more apparent.

In 1978, the Supreme Court profoundly changed the interpretation of usury laws with a ruling in the case of *Marquette National Bank of Minneapolis* v. *First Omaha Service Corp. ("Marquette")*. The solicitor general of Minnesota was attempting to prevent First Omaha from soliciting credit card customers in Minnesota at the higher Nebraska interest rates by contending that the exportation of Nebraska's interest rate would make it difficult for states to enact effective usury laws.[12] The Supreme Court agreed that such might be the case, but it decided that the usury issue was a legislative problem to be handled by Congress.[13] The Court held in *Marquette* that section 85 of the National Bank Act allowed a lender to charge the highest interest rate allowed in the lender's home state, regardless of a lower rate limitation in the customer's state of residence.[14]

The Effects of the Marquette *Decision on Credit Card Lending*

The *Marquette* decision applied to all types of consumer loans, but it had the greatest consequences for the credit card industry. Because of its use of technology in the solicitation and underwriting process, credit card lending can be accomplished entirely by mail, without the borrower and lender ever meeting. Consequently, credit card lenders headquartered in states with liberal usury ceilings can easily export their rates to borrowers residing in states with restrictive usury ceilings.

State Usury Ceilings Were Dismantled

After the *Marquette* decision, liberalization of state usury ceilings occurred. Some states quickly seized the opportunity to deregulate interest and other banking functions to attract banks and other consumer lenders. Two such states were South Dakota and Delaware. Citicorp was one of the first lenders to take advantage of deregulation at the state level. It established a new national bank and credit card processing center in Sioux Falls, South Dakota, in 1981 (Janklow 1985, 32).

The practical effect of the *Marquette* decision was to force states to deregulate or face a loss of the credit card segment of the banking business (Langevoort 1987, 686). Major banks pressured state legislatures to relax limits on lending by threatening to move their businesses to states with more liberal ceilings. The four largest banks in Maryland did move their credit card operations to Delaware when the Maryland state legislature refused to relax the state's usury laws.[15]

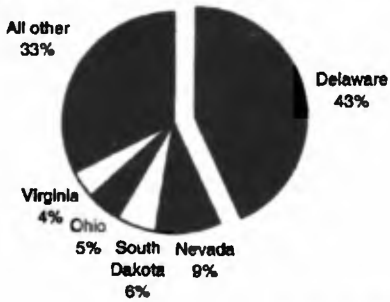
According to Ausubel (1991), most leading banking states had relaxed or repealed their interest rate ceilings by 1982, and the bank credit card market was effectively deregulated.

A Redistribution of Credit Card Lending Occurred among States

After leading banking states had deregulated their interest ceilings, a redistribution of credit card activity to those states occurred. Delaware has been the primary magnet for credit card lenders.[16] In the two years after Delaware deregulated, at least ten banks had a new, major credit card presence in Delaware. Today, six of the top ten banks with the highest volume of credit card lending are located in that state, and lenders in Delaware hold 43 percent of total credit card loans made by insured depository institutions (see Chart 2). Chart 3 illustrates the dramatic growth in credit card volumes that occurred after deregulation in Delaware.

Chart 2

Delaware Has the Largest Credit Card Volume* of any State in the United States, June 1997



*Includes securitizations

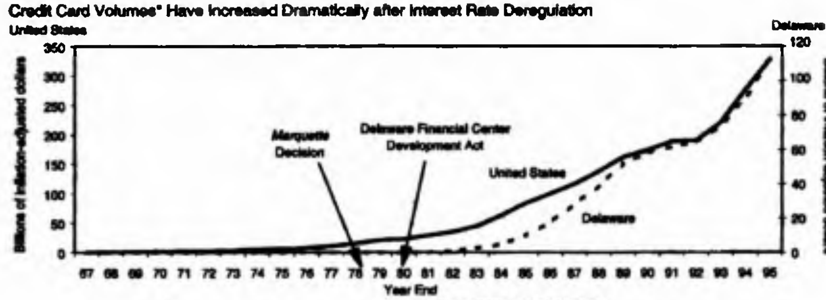
Source: Bank and thrift call reports

Credit Card Lending Has Accelerated

In addition to a redistribution of lending to certain states, growth in credit card lending has accelerated throughout the United States. Since the *Marquette* decision, total credit card loans have grown at a rapid pace compared with the previous decade (see Chart 3). According to the Federal Reserve *Survey of Consumer Finances*, the percentage of households with at least one credit card account grew from 38 percent in 1977 to 43 percent in 1983 to 54 percent in 1989 (GAO 1994, 13). Credit cards have revolutionized consumer debt and have become firmly entrenched as means of financing household purchases.

Chart 3

Credit Card Volumes* Have Increased Dramatically after Interest Rate Deregulation



*Does not include off-balance-sheet securitizations.

Source: Bank call reports (credit card and related plans of insured commercial banks).

The Benefits of Holding Credit Cards Have Increased

As credit cards have become more widely held, collateral benefits of holding credit cards have arisen (Baxter 1995, 1022). More merchants have started accepting credit cards, which has made paying for goods and services more convenient for consumers. Also, entire industries, such as the catalog/phone order industry, have emerged as a result of the widespread acceptance of credit cards.

The expansion of the credit card industry and increased competition also have resulted in financial innovations (Baxter 1995, 1022), such as balance transfer offers that have reduced the cost of switching to a new credit card that offers better terms. Furthermore, in addition to competing on price, credit card lenders have developed a wide array of price-service options. Credit cards that offer frequent flyer miles, cash rebates, or credit toward future purchases of goods such as gasoline, groceries, and cars have become the standard.

How Could Interest Rate Deregulation Trigger an Increase in the Number of Personal Bankruptcies?

The remainder of this paper analyzes how interest rate deregulation altered the consumer credit market and how lenders and borrowers reacted to this change. The paper develops a "change in credit markets" hypothesis that deregulation altered the consumer credit markets and triggered a substantial increase in consumer credit availability, charge-off rates, and personal bankruptcies.

Lenders Will Expand Credit Availability in a Deregulated Environment

One of the most important results of the shift to a deregulated environment was that lenders found it profitable to grant credit to individuals who had been shut out of the market in a regulated environment. Lenders were no longer discouraged by restrictive usury ceilings from lending in certain states. Consequently, lenders extended the geographic breadth of their activity, and major credit card lenders with a nationwide presence emerged.

After the dismantling of usury laws, lenders also extended the depth of the credit card market in order to increase their market share and profitability. For example, low-income borrowers received unprecedented access to credit. Empirical tests of credit card lending prior to the *Marquette* decision confirm that restrictive usury ceilings resulted in limited credit availability for low-income individuals. Two such studies, a Credit Research Center study and a New York State study, found that pre-*Marquette* rate ceilings affected the probability that a low-income or lower-middle-income family would hold a credit card but did not affect the probability of cardholding of higher income families (Baxter 1995, 1023). The wider access to credit that occurred after interest rate deregulation is sometimes referred to as the "democratization of credit."

High-risk Borrowers Will Receive More Credit in a Deregulated Environment

Another group that benefited from the expansion of credit was high-risk borrowers, or individuals with poor credit ratings regardless of their income level. The ability to generate more income allowed lenders to lend to individuals who were further down the spectrum of credit quality because lenders could be compensated for a higher rate of credit losses. Lenders were able to increase their profitability by expanding their lending volume while taking on a greater degree of credit risk. As discussed earlier, a restrictive usury regime resulted in significant credit rationing, with high-risk borrowers being shut out of the market. When interest rates were deregulated, less credit rationing occurred, and higher risk borrowers were allowed into the market.

Lenders Will Set Price According to the Credit Quality of the Borrower

Among the factors that lenders consider when pricing credit, the credit quality of the borrower is an important one. High-risk borrowers, as a group, usually are charged higher interest rates to compensate for their higher default rates. In setting price, lenders assume that the average credit quality of borrowers in a portfolio will decline as the portfolio interest rate rises. This outcome occurs because higher quality borrowers tend to decline to borrow at high interest rates because they usually have other sources of credit. Borrowers with poorer credit qualities usually have fewer borrowing options and, consequently, will remain willing to borrow at higher interest rates.

In short, borrowers have different price sensitivities. Therefore, a lender can maximize revenues by segmenting borrowers into different credit groups and charging them different rates. Charging a higher price to credit groups that are less price sensitive and charging a lower price to credit groups that are more price sensitive will increase a lender's profitability over charging a single price for every credit group.

Average Credit Card Interest Rates Will Rise in a Deregulated Environment

Because lenders tend to set prices according to the credit quality of the borrower, another result of the shift to a deregulated environment is an increase in the average credit card interest rate. The new customers allowed into the credit markets tend to be charged higher interest rates because of their poorer credit ratings. Consequently, average borrowing costs across the spectrum of borrowers are likely to be higher in a deregulated environment.

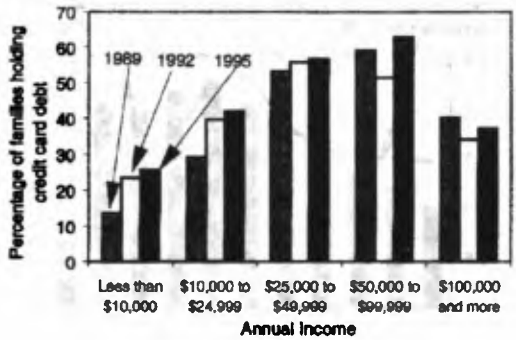
Consumers Will Borrow More in a Deregulated Environment

One consumer response to interest rate deregulation was to take advantage of the increased supply of credit to borrow more. Individuals who could already obtain credit card loans in a highly regulated environment did not necessarily benefit from the increased access to credit, but they were able to increase their holdings of credit cards and take advantage of the cards' increased acceptance by merchants. This development gave rise to the "convenience users," who use credit cards for their convenience over cash or checks but pay the outstanding balance in full each month to avoid interest charges. Higher quality borrowers who wanted to borrow occasionally were able to take advantage of financial innovations such as balance transfer options, which allow consumers to shop for interest rates and easily transfer existing balances to the most competitive lender.

After deregulation, there also was an increase in the number of consumers with outstanding credit card balances, even at high rates of interest. As discussed in the introduction, one interpretation of this trend is that borrowers exhibit irrational behavior. Another explanation is that some households would be expected to have a need to finance current consumption that outweighs the cost of borrowing. Such households include those with limited financial means. Indeed, as illustrated by Chart 4, in recent years the growth in the percentage of families holding credit card debt has been fastest in the lowest income bracket.

Chart 4

The Fastest Growth in the Credit Card Market Has Been at the Lowest Income Brackets



Source: Federal Reserve Board Survey of Consumer Finances

Low-income households are not the only ones with a high propensity to borrow. Young households, which have yet to reach their prime earning years, and households with volatile incomes that are experiencing an off year are more likely to take on debt, even at high interest rates. They may be willing to borrow at high rates of interest on occasion with the expectation that future income will enable them to repay their debts.[17]

Interest rate deregulation resulted in greater access to credit for individuals with a high propensity to borrow. This access to credit created a new class of risky borrowers.

More Borrowers Will Experience Credit Problems in a Deregulated Environment

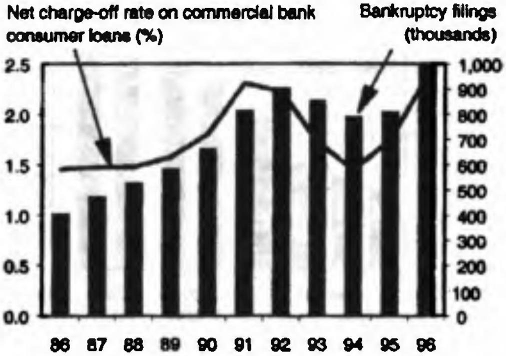
One of the consequences of more consumer borrowing can be an increase in credit problems. Credit problems are not unique to low-income households; any household that takes on debt increases its risk of credit problems. Deregulation expanded opportunities for households, particularly those with a high propensity to borrow, to take on debt. One of the implications of some households' higher propensity to borrow is that they will tend to experience higher financial leverage at the margin. Higher financial leverage increases a household's exposure to financial shocks, such as job loss, illness, and divorce, which are events often cited as reasons for personal bankruptcies.

The fact that access to credit has come largely in the form of credit card loans, rather than some other form of consumer loan, is an important factor in rising credit problems. Credit card loans are unsecured, general-purpose loans that can be granted in small denominations. Even for the best borrowers, they usually carry a much higher interest rate than other forms of consumer loans. Consequently, borrowers may turn to credit card lenders as a kind of "lender of last resort" when other less expensive means have been exhausted. Moreover, consumers who are heavy users of credit card loans probably have limited financial resources elsewhere and are the most at risk for credit problems. Finally, the fact that these borrowers are likely paying high interest rates compounds their risk for credit problems.

Lenders Will Experience More Credit Losses in a Deregulated Environment

One of the implications of borrowers having more credit problems is that lenders will experience higher charge-off rates. Chart 5 shows the close relationship between the rising U.S. personal bankruptcy rate and the consumer charge-off rate for commercial banks, which is being driven by charge-offs on credit card loans.

Chart 5
There Is a Close Link Between Bankruptcies and Charge-Offs



Source: Administrative Office of the U.S. Courts, Bureau of Census, Federal Reserve Board

Despite rising charge-off rates, credit card lenders on average have been able to maintain profitability. The willingness of some individuals to borrow at high interest rates and their ability to repay is critical to offset banks' losses on those who default.

The Canadian Experience

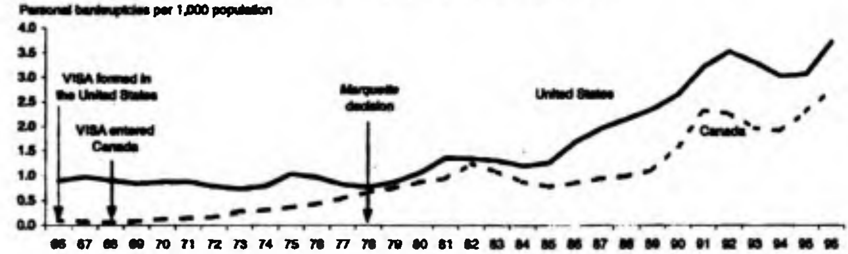
This paper has argued that interest rate deregulation altered the credit markets and led to a substantial expansion in credit card availability and an increase in the level of personal bankruptcies. This argument can be tested by analyzing the experience in Canada, because the modern history of credit cards in Canada is very similar to the U.S. history. In 1968, two years after the development of the VISA and MasterCard associations in the United States, VISA entered Canada, resulting in a dramatic growth in credit card loans (*Canadian Banker* 1994).

However, there were significant differences at that time between U.S. and Canadian laws regarding interest rate regulation. Interest rates in Canada have been deregulated since at least 1886, when the Interest Act of Canada was passed (*Financial Post* 1994). This act permits a lender to charge any rate of interest that is agreed upon (Hutchison 1986). Therefore, although the modern-day credit card industry got its start at the same time in the two countries, there were no legal limits that restricted credit availability in Canada, as there were in the United States.

Credit card outstandings have grown dramatically in Canada in the past two decades, as they have in the United States. Personal bankruptcies have grown in Canada as well. Chart 6 shows that personal bankruptcies grew sharply and immediately after the VISA association entered Canada. From 1966 to 1976, the personal bankruptcy rate in Canada grew 340 percent. Over that same period, the personal bankruptcy rate in the United States grew by only 8 percent. One explanation for this difference in rates may be that usury laws were limiting credit availability in the United States over that period, while the absence of usury ceilings in Canada was permitting the expansion of credit card debt to more high-risk borrowers.

Chart 6

Personal Bankruptcies Started Rising Sooner in Canada than in the United States



Source: Superintendent of Bankruptcy (Canada) Statistical Abstracts of the United States, Administrative Office of the U.S. Courts, and Census Bureau

Chart 6 also shows that after interest rate deregulation in the United States, the personal bankruptcy rates in both countries follow a remarkably similar pattern. Over the next decade, 1976–1986, the Canadian bankruptcy rate grew by approximately 93 percent, and the U.S. bankruptcy rate grew by 72 percent. In the decade 1986–1996, as the credit card industry underwent rapid innovation and expansion, personal bankruptcy rates in both countries grew dramatically. In Canada, the personal bankruptcy rate grew 225 percent; in the United States, it grew 123 percent.

The Canadian experience also suggests that changes in U.S. federal bankruptcy law have not been a significant factor in the rise in U.S. personal bankruptcies. Some industry experts have pointed to federal bankruptcy law reform, which occurred at roughly the same time as interest rate deregulation, as an explanation for the rise in personal bankruptcies. However, Chart 6 shows that Canada's personal bankruptcy rate has taken a very similar path to the U.S. personal bankruptcy rate since 1978, although there have been no significant recent changes to Canada's bankruptcy law (Zandi 1997).

Conclusion

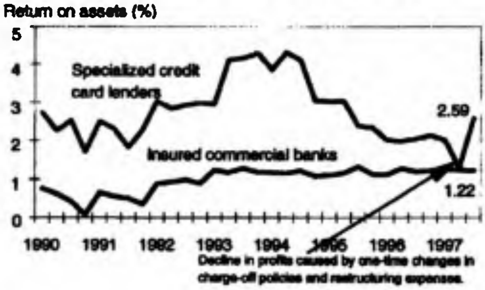
This paper argues that the deregulation of consumer interest rates in the late 1970s triggered a dramatic increase in consumer credit availability, charge-off rates, and personal bankruptcies. Deregulation has created a different consumer credit environment than existed before the late 1970s. A tightly regulated world, marked by unrestricted access to credit and a low level of personal bankruptcies, has been exchanged for a deregulated world, marked by expanded access to consumer credit and a higher level of personal bankruptcies. This argument suggests that the personal bankruptcy rate may be rising toward a new "norm" and is unlikely to reverse itself to the levels experienced in the 1970s.

Despite the costs associated with a higher level of personal bankruptcies, the results of deregulation have not been all negative. Deregulation has resulted in more choice for consumers, particularly those with poorer credit ratings.

For lenders, deregulation has expanded market options and increased profit opportunities. The opportunity to earn high profits has attracted intense competition, which appears to be eroding some of the high profits earned in the early 1990s (see Chart 7). Chart 8 shows that the volume of credit card solicitations remains at high levels, despite high rates of personal bankruptcies and credit card charge-offs, suggesting that the expansion of credit is ongoing. This ongoing expansion suggests that the process of expansion of credit to new market segments described in this paper is continuing.

Chart 7

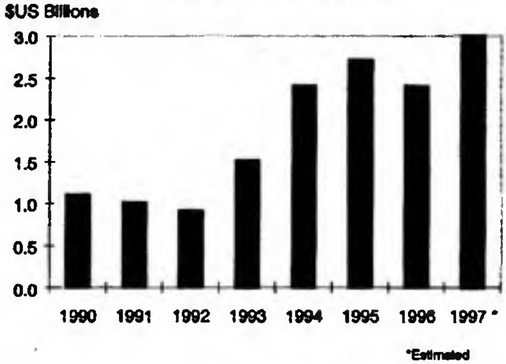
Credit Card Lending Is a Very Profitable Line of Business, Despite Recent Declines in Returns



Source: Bank call reports

Chart 8

Credit Card Solicitations Continue to Rise



Source: BAI Global

Endnotes

[1]The quote is from Elissa Buie of the Financial Planning Group Inc. in Falls Church, Virginia, in the January 11, 1998, *Washington Post.*

[2]The Bankruptcy Reform Act of 1978 established the current federal bankruptcy code. Under the 1978 act, discharge or dismissal of a debtor's financial obligations was made readily available with a number of excepted debts, and federal asset exemption levels were established that were higher than many of the state levels. The Bankruptcy Reform Act of 1994 expanded eligibility for Chapter 13 filings and doubled all dollar amounts for exempt property in Chapter 7 under the federal plan.

[3]Deuteronomy 23: 19–20 states, "Thou shalt not lend upon usury to thy brother; usury of money, usury of victuals, usury of anything that is lent upon usury: Unto a stranger thou mayest lend upon usury; but unto thy brother thou shalt not lend upon usury; . . ."

[4]Plato writes that those men who owe money and those who have lost their property are "eager for revolution," while:

> on the other hand, the men of business, stopping as they walk, and pretending not even to see those whom they have already ruined, insert their sting—that is, their money—into someone else who is not on his guard against them, and recover the parent sum many times over multiplied into a family of children: and so they make drone and pauper to abound in the State. (Moser 1997, 6.)

[5]See Ackerman 1981, 85.

[6]For a more detailed explanation of the development of the credit card industry, see GAO, 1994, 10–11.

[7]Section 85 of the National Bank Act states in relevant part:

> Any association may take, receive, reserve, and charge on any loan or discount made, or upon any notes, bills of exchange, or other evidence of debt, interest at the rate allowed by the laws of the State, Territory, or District where the bank is located, or at a rate of 1 per centum in excess of the discount rate on ninety-day commercial paper in effect at the Federal reserve bank in the Federal reserve district where the bank is located, whichever may be the greater, and no more, except that where the laws of any State a different rate is limited for banks organized under state laws, the rate so limited shall be allowed for associations organized or existing in any such State under this chapter [title 62 of the Revised Statutes]. (Rougeau 1996, 9, note 28.)

[8]The study by Canner and Fergus (1987) includes a survey of individuals in Illinois, Louisiana, Wisconsin, and Arkansas that found that higher usury ceilings on credit card lending restrict credit availability. Arkansas had a significantly lower usury rate (10 percent) than did the other states (18 percent, 21.6 percent, and 18 percent, respectively). The survey data show that families residing in Arkansas were significantly less likely to hold bank credit cards than were families living in one of the other three states.

Villegas (1989) analyzed data in the 1983 Survey of Consumer Finances and found that restrictive usury ceilings reduce the overall supply of credit and that high-risk borrowers are the hardest hit by this cutback.

[9]For a more detailed discussion of the actions taken by Sears, see Mandell 1990, 100.

[10]Reference for remainder of paragraph is Mandell 1990, 71–72. Mandell credits survey of state usury rates prepared by Professor Robert W. Johnson of Purdue University's Credit Research Center.

[11]For a more detailed discussion of the changing attitudes regarding usury, see Rougeau 1996.

[12]Ibid.

[13]Ibid, 9–10.

[14]Ibid., 9.

[15]Maryland Bank, N.A., the state's largest bank at the time, moved its credit card operations to Delaware early in 1982 and was followed shortly thereafter by First National Bank of Maryland, Equitable Trust Co., and Suburban Bank. All together, these banks had incurred losses of almost $19 million on their credit card operations the year before but showed profits on other operations. (Muscatine 1982, B1, and American Banker 1982, 2.)

[16]Delaware's 1981 Financial Center Development Act abolished rate limitations on all classes of loans, liberalized Delaware's consumer lending law, and established a favorable tax structure for banks. (Eckman 1984, 1264–1265.)

[17]This proposition is based on the permanent income hypothesis developed by Milton Friedman (1957). Friedman posited that consumers tend to base their choice of present consumption largely on their expected lifetime income and will tend to borrow or lend at prevailing interest rates if their choice of current consumption is different from current income. This hypothesis gives credence to the idea that households may differ a great deal in terms of their willingness to take on debt.

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About the Author

Diane Ellis is a Senior Financial Analyst in the Economic Analysis Section of the Division of Insurance.

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The views expressed in this article are those of the author(s) and do not necessarily reflect the official position of the Division of Insurance or the Federal Deposit Insurance Corporation.

National CEBA Credit Card Banks With No Retail Affiliates

Charter Number	Credit Card Bank Name (Ultimate Parent) City, State Control Number (Date Approved, if an organization)	Date Opened
	OPENED	
15033	Advanta National Bank USA [formerly Colonial National Bank USA] (Advanta) Wilmington, DE [Relocated from Claymont on 12/02/96] [grandfathered non-bank bank, status to non-bank bank consummated 01/21/82]	12/14/62
22277	Associated National Bank (Delaware) (Ford Motor Corp.) Wilmington, DE 90WE010008	04/05/91
22474	Beneficial National Bank USA (Beneficial Financial Corp.) Wilmington, DE 91NE010008	02/21/92
21099	Dial National Bank (Norwest Financial Services, Inc.) Des Moines, IA 85MW010016	12/01/88
22869	Firstar Bank U.S.A., National Assocation [formerly Firstar Credit Card Bank, National Association] (Firstar Corporation) Waukegan, IL 95CE010002	07/03/95
23125	First Financial Card Services Bank, Nation Association (First Financial Corporation) Stevens Point, WI 1996CE010022	07/19/96
23342	First Union Direct Bank, National Association (First Union Corporation) Augusta, GA [Relocated from Atlanta on 06/02/97] 1997ML010001 & 1997ML020015	06/02/97
18767	Household Bank (Illinois), National Association [formerly HRSI, National Association] (Household International Financial Company) Prospect Heights, IL 88CE010021	04/02/90
18818	Household Bank (Nevada), National Association (Household International Financial Company) Las Vegas, NV 92WE010003	04/01/93
22675	Household Bank (SB), National Association (Household International Financial Company) Las Vegas, NV 93WE010004	12/01/93

National CEBA Credit Card Banks With No Retail Affiliates—Continued

Charter Number	Credit Card Bank Name (Ultimate Parent) City, State Control Number (Date Approved, if an organization)	Date Opened
18788	JCB Bank, National Association JCB International Credit Card Company (Ltd) (JCB USA) Los Angeles, CA 91WE010005	05/03/93
23227	PNC National Bank (PNC Bank) Wilmington, DE 96NE010021	12/20/96
22028	Providian National Bank [formerly First Deposit National Credit Card Bank] (Providian Corporation) Concord, NH 89NE010007	12/28/90
22974	UMB U.S.A., National Association (UMB Financial Corporation) United Missouri Bank, N.A. Falls City, NE 95MW010025	05/01/96
23116	United Credit National Bank (United Insurance Companies, Inc.) Sioux Falls, SD 96MW010011	02/03/97
22791	Universal Bank, National Association (AT&T Corporation) Columbus, GA 95SE010007/94SE110001	01/01/95
22863	Wells Fargo Bank (Arizona), National Associationa (Wells Fargo Bank) Phoenix, AZ 95ML010001	06/08/95
22696	Whirlpool Financial National Bank (Whirlpool Corporation) New Castle, DE 93NE010007	10/01/94
	IN ORANIZATION	
	None	
	PROPOSED	
23320	First Annapolis Bank, National Association (First Annapolis Consulting, Inc.) Newark, DE 97NE010001	
23363	TCM Bank, National Association (IBAA) Tampa, FL 97SE010012	

National CEBA Credit Card Banks With No Retail Affiliates—Continued

Charter Number	Credit Card Bank Name (Ultimate Parent) City, State Control Number (Date Approved, if an organization)	Date Opened
23169	United Credit Card Bank, National Association (United Companies Financial Corporation) Baton Rouge, LA 96SW010014	

National CEBA Credit Card Banks With Retail Affiliates

Charter Number	Credit Card Bank Name (Ultimate Parent) City, State Control Number (Date Opened) (Date Approved, if in organization)	Retail Affiliate
	OPENED	
23139	Chevron Credit Bank, National Association (Chevron U.S.A., Inc.) Murray, UT 96WE010004 (12/13/96)	Chevron
22594	Credit First National Association (Bridgestone/Firestone, Inc.) Brook Park, Ohio 92CE010010 (10/19/93)	Bridgestone Firestone
18777	Dillard National Bank (Dillard Department Stores) Dillard Investment Company Gilbert, AZ [Relocated from Phoenix on 12/30/96] 90WE010009 (06/18/91)	Dillard Department Stores
22734	Direct Merchants Credit Card Bank, National Association (Fingerhut Companies, Inc.) Salt Lake City, UT 94WE010001 (02/14/95)	Fingerhut Companies
23097	DSRM National Bank (Diamond Shamrock Inc.) Diamond Shamrock Refining & Marketing Co. Albuquerque, NM 96SW010005 (10/01/96)	Diamond Shamrock Gas Stations
23154	Eaglemark Bank, National Association (Eaglemark Financial Services, Inc.) Carson City, NV 96WE01005 (08/25/97)	Harley-Davidson
22579	FDS National Bank (Federated Department Stores) Deerfield Township, Ohio 92CE010007 (9/8/93)	Bloomingdales Abraham & Straus Jordan Marsh Bon Marche Burdines Lazarus Rich's/Goldsmith Stern's

National CEBA Credit Card Banks With Retail Affiliates—Continued

Charter Number	Credit Card Bank Name (Ultimate Parent) City, State Control Number (Date Opened) (Date Approved, if in organization)	Retail Affiliate
23083	Fingerhut National Bank (Fingerhut Companies, Inc.) Sioux Falls, SD 96MW010006 (11/11/96)	Fingerhut Companies
21688	First Consumers National Bank (Spiegel, Inc.) Beaverton, OR 87WE010031 (12/12/88)	Spiegel Eddie Bauer
22196	First North American National Bank (Circuit City Stores, Inc.) Marietta, GA 90SE010005 (11/19/90)	Circuit City Stores
22465	JCPenney Card Bank, National Association (JC Penney Company) Harrington, DE 91NE010007 (07/16/93)	J C Penney Stores
3883	JCPenney National Bank (JC Penney Company) Harrington, DE [Grandfathered non-bank bank, opened 5/9/ 1888, non-bank bank status approved 06/26/1983]	J C Penney Stores
21920	May National Bank of Arizona (May Department Stores, Inc.) Tempe, AZ 88MW010016 (04/01/91)	Meier & Frank Robinson's - May L.S. Ayres Famous - Barr
21922	May National Bank of Ohio (May Department Stores, Inc.) Lorain, OH [Relocated from Parma on 10/01/96] 88MW010018 (05/01/91)	Hecht's Lord & Taylor Strawbridge Kaufmann's
22473	MCFC National Bank (Mobil Corporation) Lenexa, KS 91MW010005 (05/31/95)	Mobil Oil Company
23324	Mercantile Stores National Bank (MERSCO Finance Corporation) Baton Rouge, LA 97SW010001 (06/24/97)	Mercantile Stores Company, Inc.
22894	National Bank of the Great Lakes (Carson Pirie Scott & Company) Elmhurst, IL [Relocated from Hillside on 06/27/97] 95CE010005 (02/04/96)	Carson Pirie Scott Department Stores
22195	Nordstrom National Credit Bank (Nordstrom, Inc.) Englewood, CO 90WE010006 (08/30/91)	Nordstrom Department Stores

National CEBA Credit Card Banks With Retail Affiliates—Continued

Charter Number	Credit Card Bank Name (Ultimate Parent) City, State Control Number (Date Opened) (Date Approved, if in organization)	Retail Affiliate
22549	Retailers National Bank (Dayton Hudson Corporation) Sioux Falls, SD 92MW010002 (01/07/94)	Target Mervyn's Dayton's Marshal Field's Hudson's
20670	Sears National Bank [formerly American National Bank of Arizona] (Sears, Roebuck and Company) Tempe, AZ [Relocated from Phoenix on 03/31/97] 93WE110005 ["Converted" from a commercial to a CEBA credit card bank on 1/31/94]	Sears
22183	Spirit of America National Bank (Charming Shoppes, Inc.) Milford, OH 90CE010001 (09/04/91)	Fashion Bug Fashion Bug Plus
22568	Pier One National Bank (Pier One Imports) Omaha, NE [formerly Texico Credit Card Bank, National Association, owned by Texico Oil Company. Change in bank control consummated 05/01/97] 92MW010004 (12/01/94)	Pier One Imports
21739	World Financial Network National Bank (The Limited, Inc.) Whitehall, OH 88CE010002 (05/01/89)	The Limited Limited Express Lerner Lane Bryant Victoria's Secret Lerner Woman Henri Bendel Brylane (Catalog Sales)
	IN ORGANIZATION	
23403	Jewelers National Bank (Zale Corporation) Tempe, AZ 97WE010002 (08/04/97)	Zale Jewelry Stores
	PROPOSED	
23323	Cedar Hill National Bank (Cato Corporation) Lawrenceville, GA 97SE010002	Cato Clothing Stores

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Other Credit Card Banks, Non-Bank Banks, and Banks Approved as Wholesale and Limited Purpose Banks Under CRA

Charter Number	Bank Name City, State Control Number (if any) (Date Charter Approved if known)	Date Opened
18174	American Investment Bank, National Association Salt Lake City, UT {10/28/83}	04/02/84
16595	Avco National Bank (Avco Enterprises, Inc.) Costa Mesa, CA [Relocated from Anaheim on 08/30/95] {06/30/82}	07/16/82
23239	BankBoston (NH), National Association (Bank of Boston Corporation) Nashua, NH {12/20/96}	04/24/97
17112	Banker's Trust Florida, National Association Palm Beach, FL	11/09/81
23160	The Chase Manhattan Bank, USA, National Association Wilmington, DE 96WE010014 {08/09/96}	08/19/96
18021	Comerica Bank-Midwest, National Association Toledo, OH {08/02/83}	12/15/83
16971	Citibank (South Dakota), National Association Sioux Falls, SD	02/19/81
20500	Commerce Bank, National Association Omaha, NE 84MW010226 {05/16/85}	10/01/85
20612	Delta National Bank and Trust Company of Florida Miami, FL 84SE010273 {03/29/85}	02/02/87
20547	Delta National Bank and Trust of New York New York, NY 84NE010396 {03/29/85}	03/17/86
22404	EFS National Bank (Concord Computing Corporation) Memphis, TN 91SE010002 {01/13/92}	12/01/92
17762	FCC National Bank Wilmington, DE {03/03/83}	05/11/83
1333	First Deposit National Bank Tilton, NH (Non-bank bank status approved 05/18/1981)	06/23/1865
20291	First National Bank of Marin San Rafael, CA 84WE010244 {07/09/84}	07/30/84

Other Credit Card Banks, Non-Bank Banks, and Banks Approved as Wholesale and Limited Purpose Banks Under CRA—Continued

Charter Number	Bank Name City, State Control Number (if any) (Date Charter Approved if known)	Date Opened
17295	First Omni Bank, National Association Millsboro, DE	05/07/82
23177	Fleet Bank (Delaware), National Association Wilmington, DE (Fleet Financial Group) 1996ML010004 (11/07/96)	05/06/97
22908	Key Bank USA, National Association Cleveland, OH 95CE010012 (06/08/95)	09/05/95
22381	MBNA America Bank, National Association (Maryland Bankcorporation) Wilmington, DE [Relocated from Newark on 06/01/96] 91NE010001 (01/28/91)	01/29/91
22859	M & T Bank, National Association Oakfield, NY 94NE010015 (06/29/95)	10/02/95
22279	NationsBank of Delaware, National Association (NationsBank Corporation) Dover, DE 90ML010001 (08/08/90)	12/13/90
20010	Pacific National Bank Miami, FL 84SE010204 (06/18/84)	07/22/85
20962	The Park Avenue Bank, National Association New York, New York 85NE010013 (11/18/85)	11/06/87
22670	PNC Mortgage Bank, National Association Pittsburgh, PA 93NE010004 (11/24/93)	11/30/93
22626	SunTrust BankCard, National Association Orlando, FL 93SE010001 (04/23/93)	07/06/93
22413	U.S. Trust Company of California, National Association Los Angeles, CA 91WE020004 (03/08/91)	03/08/91
18782	U.S. Trust Company of Texas, National Association Dallas, TX 90SW020096 (12/07/90)	12/07/90

Other Credit Card Banks, Non-Bank Banks, and Banks Approved as Wholesale and Limited Purpose Banks Under CRA—Continued

Charter Number	Bank Name City, State Control Number (if any) (Date Charter Approved if known)	Date Opened
22611	Waterhouse National Bank White Plains, NY 92NE010006 (08/19/93)	10/13/94
22897	Wells Fargo HSBC Trade Bank, National Association San Francisco, CA 95ML010003 (06/16/95)	10/05/95
	Proposed	
23401	Credicard National Bank San Antonio, TX (Steward Armstrong) 97SW010007	

COMPTROLLER OF THE CURRENCY,
ADMINISTRATOR OF NATIONAL BANKS,
Washington, DC, November 25, 1997.

Beverly M. Burden,
United States Bankruptcy Court for the Eastern District of Kentucky,
Chambers of Judge Joe Lee,
Lexington, KY

DEAR BEVERLY M. BURDEN: This is in response to your Freedom of Information Act request dated November 10, 1997, received in my office on November 12, 1997. Your request, 97–1787, has been granted.

You requested: list of credit card banks. Materials relevant to your request are enclosed with an invoice for charges, if any.

Sincerely yours,

PAMELA F. DOUGLAS,
PUBLIC DISCLOSURE UNIT,
COMMUNICATIONS DIVISION.

Mr. GEKAS. We may get back to you during the question-and-answer period, Judge Lee.

Mr. Forman, please, for 5 minutes.

STATEMENT OF LEON S. FORMAN, ESQUIRE, BLANK, ROME, COMISKY AND McCAULEY, PHILADELPHIA, PA

Mr. FORMAN. Thank you, Congressman, for this invitation. It is an honor to be here.

My remarks will concern the impact of bankruptcy on creditors and how H.R. 833 addresses this issue. We all know that the rights of creditors are substantially altered when a bankruptcy occurs. The assets are in the jurisdiction of the court. The automatic stay prevents creditors from taking any action. Contracts may be rejected. Claims are discharged, and creditors will receive a distribution in the court if there are any assets.

Some creditors get better treatment than others. If they are secured, they are able to get the benefit of their collateral, and then

Congress has provide da limited group of priorities for some creditors, such as wage earners and for taxes.

Despite these substantial impacts on creditors, bankruptcy is still better than not having any such system at all when a debtor is in financial trouble. Bankruptcy avoids a race by the diligent creditors under State law, and where some will do much better than others and others will get nothing.

I resent the implications of Mr. Skeel that bankruptcy lawyers encourage bankruptcies. That is just not true. I will be 84 in about 2 weeks. I have been practicing 60 years. I have never encouraged a client to go into bankruptcy if he could work out or she could work out their problems outside of bankruptcy, and I am sure that is true of most good lawyers.

That is like saying that doctors and hospitals who thrive on illness encourage sickness. Of course, they do not, and the answer is that we would be much better to practice preventive law than treating people who become ill afterwards.

Bankruptcy is based on a concept of equality of treatment except for, of course, secured creditors and the few priority groups, and, of course, there are non-dischargeable debts.

It is for that reason that Congress should move slowly in changing the priorities, increasing priorities, or increasing non-dischargeable debts. They should be very strictly limited.

Chapter 11 is the reorganization chapter, and it is designed to preserve a business and not liquidate it. The debtor and the creditors are supposed to negotiate and try to reach a consensual plan, and to do this fairly and properly, their rights under the law should be balanced. They need a level playing field, no side having a big advantage.

H.R. 833 unbalances that playing field, and most often hurts debtors. The chances of a plan are made more difficult, and let me give you a few examples.

Section 213 amends 1121 to preclude the extension of the exclusivity period, in which the debtor has to file a plan, beyond 18 months. That may be acceptable in small cases, but it is too arbitrary in the larger cases where more flexibility is needed. It gives the creditor too much advantage by giving him the opportunity to merely wait out the 18 months and then creditors are in a position to file their own plan. The exclusivity period is the period of time of 120 days, given under 1121 whereby the debtor alone can file a plan, but that period can be extended from time to time by the court.

Section 1101 amends the definition of single-asset real estate to eliminate the $4-million cap, leaving the definition without limit. Where there is no limit, this may be a serious mistake of policy because then the expedited procedure mandated for such cases would apply to the large mega real estate cases, such as, for example, Rockefeller Center which a few years ago was in bankruptcy.

These large cases cannot generally be reorganized under this expedited procedure that has been set up in the Code for small single-asset real estate cases.

The expedited procedure requires a plan to be filed within 90 days or payments made on account of the secured debt.

Increasing the cap has merit, but it should be increased to somewhere around 14- to $15 million, and there is absolutely no basis for eliminating the cap entirely.

There are other changes which I think the proposal makes unfortunately in the situation of Chapter 11, but my time is up and I would refer you to a letter which I wrote to the Judiciary Committee at the request of Peter Levinson on November 12, 1998, in which I reviewed extensively the provisions of 3150. I understand H.R. 833 is an exact duplicate of 3150. I would refer the subcommittee to that letter which has a great deal of detail on this subject.

I understand that the staff has copies of it and it has been attached to my presentation, and will become part of the record.

Thank you.

[The prepared statement of Mr. Forman follows:]

PREPARED STATEMENT OF LEON S. FORMAN, ESQUIRE, BLANK, ROME, COMISKY AND McCAULEY, PHILADELPHIA, PA

BIOGRAPHICAL SKETCH

Mr. Forman is counsel to the firm of Black Rome Comisky & McCaulty LLP. He is a member of the firm's Financial Services Department. He has concentrated his practice for almost 60 years on bankruptcy reorganizations and banking and commercial lending matters. He received his J.D. fro the University of Pennsylvania Law School where he was a member of the Board of Editors of the Law Review and following graduation was awarded a Gowen Memorial Fellowship for an additional year of study. Mr. Forman is a member of the National Bankruptcy Conference, the American Law Institute, a Scholar-in-Residence of the American College of Bankruptcy and was the first Chairman of the Eastern District of Pennsylvania Bankruptcy Conference. He has authored a number of articles in the field of creditors rights and various legal periodicals and is a contributing editor to the Collier Practice Guide and a co-author of "Fundamentals of Bankruptcy Law," published by ALI/ABA, as well as other legal publications. He has lectured in bankruptcy law at Temple Law School and the University of Pennsylvania Law School and has been a planning chairman and panelist for numerous seminars and educational programs sponsored by ALI/ABA and other organizations. He is the 1998 recipient of the Distinguished Service Award of the American College of Bankruptcy.

A STATEMENT OF THE INTEREST OF CREDITORS IN A BANKRUPTCY CASE

Bankruptcy is a collective proceeding. One of its goals is the equal treatment of creditors with similar legal rights outside of bankruptcy. Although we tend to think narrowly about the definition of a creditor, creditors come in all shapes and sizes: banks, finance companies, mortgage companies, automobile lenders, credit unions, credit card companies, retailers, equipment lessors, rent-to-own establishments, franchisers, landlords, employees, children, ex-spouses, relatives, neighbors, doctors, dentists, barbers, newspaper deliverers, federal, state and local taxing authorities, trade suppliers, parochial schools, charitable organizations, utility companies, and tort victims all may be creditors. Enhancement of the treatment of one type of creditor often comes at the cost of another. It is important to evaluate the Bankruptcy Reform Act of 1999 (H.R. 833) with this in mind. For this reason, my testimony addresses how the bankruptcy system deals with creditor interests, many of which are competing for limited resources.

The filing of a bankruptcy petition has a substantial impact on its creditors. It represents a cleavage in the economic life of the debtor. The occurrence of a bankruptcy proceeding automatically creates an estate consisting of all interests of the debtor in property. The debtor's assets are in *custodia legis*, subject to the pervasive jurisdiction of the Bankruptcy Court. The status of pre-petition claims and rights is determined as of the date of bankruptcy and such pre-petition claims and rights are generally separated from events and claims arising after the date of the petition.

In order to implement the above concept, the filing of a bankruptcy petition under the Bankruptcy Code automatically operates as a stay against lawsuits and lien enforcement. The purpose of the stay is to provide the protection necessary for administering the assets of the estate and to relieve the debtor from the pressure of creditor collection efforts. Creditors may not, while the stay is in effect, exercise their normal legal remedies without first obtaining a court order from the bankruptcy court unless their remedy falls within an exception to the automatic stay under subsection (b) of section 362 of the Bankruptcy Code. In that respect, the rights of creditors are substantially altered. Creditors may only pursue their claims by filing them against the debtor and the estate in the bankruptcy proceeding.

Secured creditors are also effectively controlled by the automatic stay. They may not foreclose on their collateral or exercise other rights in their security except as may be permitted by a properly obtained court order. Moreover, in chapter 11, the debtor-in-possession or trustee may use collateral of a secured creditor subject to certain safeguards that ensure the protection of the creditor's interest. The secured claim is also limited by a valuation process and the claim will be allowed as a secured debt, restricted to the value of the collateral. If there is a deficiency in the total amount of the claim, the amount exceeding the value of the collateral is treated as a general claim along with all other such claims.

For the most part, creditors may litigate their rights and claims only in the bankruptcy court, subject to bankruptcy procedures. As a general rule, they may not use state court remedies without permission from the bankruptcy court.

In chapter 7, the liquidation chapter, which prior to the Bankruptcy Code was called straight bankruptcy, and sometimes in chapter 11, the so-called reorganization chapter, the debtor's assets are usually liquidated by a trustee. Of course, a debtor may avoid liquidation (in which creditors generally receive a lower return) and seek rehabilitation in chapter 11 or 13, the latter being a rehabilitation proceeding available principally for individual wage earners, although sole proprietors may use chapter 13 to reorganize a small business as well. In chapter 11 or 13, the debtor retains its assets and, instead of liquidation, presents a plan of payment to creditors in whole or in part. In chapter 13, the creditors are not given the right to vote on the plan, but may object if the plan does not meet all the requirements of the statute. 11 U.S.C. § 1325. In chapter 11, creditors do vote upon the plan, but under certain conditions, the provisions of the plan may be crammed down or enforced against creditors if the court approves or confirms the plan upon finding that the requirements of the Bankruptcy Code have been met. 11 U.S.C. § 1129. Thus, the rights of creditors may be seriously affected in a bankruptcy proceeding.

Some creditors in bankruptcy are treated better than others but such preferential treatment generally is intended to reflect their rights outside of bankruptcy. Secured creditors are usually entitled to the benefit of their collateral or its proceeds ahead of the interest of other parties as long as the rights of a secured creditor have been properly validated under state law and are not avoided by some applicable provision of the Bankruptcy Code. In addition, Congress has established a system of priorities giving to certain creditors precedence in distribution over other unsecured claims. 11 U.S.C. § 507. Historically, these priorities fit into narrow categories and are strictly construed. They represent an overriding policy of Congress in favor of a small and limited group of claimants. The first priority is for administrative expenses. Bankruptcy is supposed to pay its own way and this priority is necessary for the administration of the debtor's estate. Thus, if the Bankruptcy Code did not give first priority to administrative claims, it would be difficult to operate the system and make distributions to creditors. Another priority is given to wage claims, but limited in amount and limited to wages earned within a certain period before bankruptcy. Wage earners are considered to be more vulnerable than ordinary creditors, especially in a liquidation where jobs may be lost, and their favored treatment has been a longstanding policy of Congress. Another important priority is given to tax claims with some limitations. Taxes have always been favored as a governmental policy. The other priorities are restricted to very special situations in which Congress has found a policy basis for the category. To the extent that priority claims exist in a bankruptcy case, the rights and claims of general creditors are, of course, reduced. For this reason, it is critical to exercise great caution when considering whether to add other types of claims to the priority list to ensure that doing so is consistent with sound public policy.

Perhaps the most substantial alteration of the rights of creditors in bankruptcy is the discharge of their claims. This means that in most cases the debt is released and may not thereafter be enforced by the creditor. Creditors will receive a distribution in bankruptcy if there are assets to be liquidated, or a distribution under a plan in a rehabilitation proceeding, but they may not enforce their original claims. The purpose of this concept is to give the debtor a fresh start, whether as a consequence of a liquidation in chapter 7 or a reorganization in chapter 11 or 13. A promise by the debtor during a bankruptcy case to pay a pre-petition debt after bankruptcy is unenforceable unless the debtor enters into a reaffirmation agreement in accordance with the strict requirements of the statute 11 U.S.C. § 524(c), (d). Making such promises unenforceable was thought to be necessary to prevent debtors from being induced by pressure or other motives from reinstating their discharged obligations and thereby losing the benefits of the fresh start. But, unfortunately some powerful creditor interests continue to pressure debtors, sometimes in contravention of the law. Of course, an individual debtor who was engaged in certain prohibited conduct may be denied a discharge as to all debts, but the grounds for denying a discharge apply only in a chapter 7 liquidation or in a chapter 11 case that amounts substantially to a liquidation. 11 U.S.C. 727; 1141(d)(3). These grounds are not relevant in chapters 12 and 13. Objections to discharge are rare, because the grounds are difficult to prove and the proceeding may be expensive for a creditor.

Even though a discharge is granted, certain categories of debt are nondischargeable in chapter 7. 11 U.S.C. § 523. The grounds for nondischargeabiity in chapter 7 are more frequently litigated by creditors. They represent limited and specialized categories of obligations, although the list of exceptions to discharge has expanded with special interest provisions over the years. Likewise, some debts are not dischargeable even after an individual has completed a chapter 13 repayment plan. 11 U.S.C. § 1328(a). Like priority debts, exceptions to discharge should not be added absent an overwhelming public policy justification for doing so.

Creditors who have ongoing contracts with the debtor are also seriously affected by a bankruptcy case. They may not enforce their contracts in a legal proceeding without the consent of the bankruptcy court. Moreover, the debtor or trustee may reject the contract and leave the other party to an unsecured claim. Landlords may not eject debtors who are tenants as long as rent accruing during the bankruptcy proceeding is paid. Utility companies must continue to provide service, here again as long as the charges accruing during the proceeding are paid.

With the rights and claims of creditors so substantially altered by a bankruptcy case, does this mean that bankruptcy is bad for creditors, or does it work in some other way for their benefit? It is my opinion that the bankruptcy system is in the best interest of society and for the most part is better for creditors than no bankruptcy system at all.

When a debtor is unable to make payment in the absence of bankruptcy, creditors must proceed under state law. Each creditor proceeds separately and a race of the diligence ensues. Creditors compete for the limited assets of the debtor and an unequal distribution results, those creditors proceeding more promptly than others, receiving the higher rewards. The debtor's assets are dismembered and chaos results. In that situation bankruptcy is a better course of action because it enforces the principal of equality of distribution and of treatment with the limited exception of secured claims and the priorities.

If the debtor is an individual in financial distress, the discharge in bankruptcy gives the debtor a fresh start and may preserve his job, his housing and utility service. Although creditors generally lose their claims, the debtor becomes a productive member of society and is able to resume purchasing products and otherwise participate in economic and social activities. This system is much better for creditors because without bankruptcy, the creditors in most cases, would be unable to collect their debts and the debtors would merely flounder in a morass of greater financial distress. Through years of experience, suppliers of goods and services have been able to estimate the collectability of accounts receivable, and bad debts are now well recognized as a cost of doing business.

Of course, there are some abuses in the bankruptcy system just as there are in any other system in our society. But neutrally based statistics have demonstrated that the abuses are minor in scope and the court system appears to have been able to handle certainly the most egregious cases. The doctrine of good faith pervades bankruptcy jurisdiction and the statute provides many tools to address most problems. Of course, there is room for improvement in the system. The subject of exemptions is one of the more glaring areas in need of reform. A number of other suggestions have been made by responsible organizations interested in and expert in the field of bankruptcy. These suggestions, many of which are designed to promote the fair treatment of creditors, should be given more serious attention.

Chapters 11 and 13 are being used with some frequency. When successful, they avoid the liquidation of the debtor's assets and provide an opportunity for a plan of repayment and rehabilitation. Bankruptcy law provides incentives to a debtor to use these chapters, and creditors benefit from a debtor's choice to attempt to repay debts. A chapter 11 proceeding, if successful, preserves a business unit (rather than liquidating it), generally avoids the loss of jobs, and allows creditors to retain customers. In chapter 13 plans in which the debtor is able to make substantial payments, creditors will receive a return on their claims. Unfortunately, many chapter 13 cases are dismissed before a plan is confirmed or the plan deals primarily with secured and priority claims, leaving little or nothing for unsecured creditors. In addition, a large percentage of confirmed chapter 13 plans are not completed. Reliable statistical information demonstrates that an overwhelming number of debtors in financial distress are unable to support a payment program and the only reasonable relief for them is a chapter 7 proceeding. In such cases, creditors are still better off than if there was no bankruptcy system because the debtors are now free of debt and able to resume a normal productive life. They again become part of the purchasing community and a respectable credit risk. Some types of creditors, such as mortgage lenders and support recipients, actually may fare better if a debtor chooses chapter 7 over chapter 13.

CONCLUSION

Bankruptcy is an important safety valve in an imperfect economic society where free markets flourish. Most individuals and business interests intend and prefer to pay their debts. Bankruptcy still carries a stigma. Unfortunately, some debtors and businesses become so burdened with debt that bankruptcy relief is a necessary choice. In a dynamic economic society, there are bound to be upturns and downturns and provision must be made for recharging the batteries. If we consider the rapid and incredible growth of our economy and the enormous size of outstanding business and consumer debt, the increase in bankruptcy filings is not out of proportion and is an inevitable consequence.

We should, of course, continue to study and improve our bankruptcy laws, but in a reasoned and balanced way rather than based upon the proposals and views of special interests which may benefit one type of creditor to the detriment of other creditors and society in general.

It is my understanding that H.R. 833, the Bankruptcy Reform Act of 1999, is a restatement of the Conference Report on H.R. 3150 of the last Congress. If this is the case, to a great extent, this bill represents extreme proposals both in consumer and business areas. I have set forth my views with respect to the specific provisions of the Conference Bill H.R. 3150 in an attachment to my letter dated November 12, 1998, responding to a request from Peter Levinson, Esquire, counsel to the House Judiciary Committee. I respectfully would refer this Subcommittee to such comments.

AMERICAN COLLEGE OF BANKRUPTCY,
Fairfax, VA, November 12, 1998.

Via Telecopy

Peter Levinson, *Esquire,*
Counsel House Judiciary Committee,
House of Representatives, Washington, DC.

Re: American College of Bankruptcy

DEAR PETER: As you requested, I am setting forth in the attachments my views on the Conference Report Bill H.R. 3150, considered but not adopted in the last session of Congress. This, of course, is not the official position of the College, because the College has not had sufficient time to review the voluminous Committee Report.

As you know, I am also a member of the National Bankruptcy Conference and the National Bankruptcy Conference has been actively studying the Report on H.R. 3150 and will undoubtedly forward to you shortly its views. The National Bankruptcy Conference is also endeavoring to prepare an independent Bill setting forth what we believe would represent more balanced and fairer modifications of bankruptcy law, for submission to the new Congress.

In light of the volume of the Conference Report in H.R. 3150 and the short time available, I have confined my comments to what I thought were the more important provisions. Some of the provisions on which I have not commented are not objectionable or the problems are largely technical and will surely be covered by forthcoming submissions of the National Bankruptcy Conference.

If I can be of further assistance, do not hesitate to let me know.

Sincerely,

LEON S. FORMAN

CONSUMER PROVISIONS

There are, of course, some abuses in bankruptcy filings. These should be and can be corrected by modest changes. However, according to neutral studies of bankruptcy cases which are supported by government statistics, and contrary to the biased reports of special interest groups, the overwhelming number of Chapter 7 cases filed by individuals are the result of some personal tragedy combined with a high debt burden, and these individuals are almost always unable to support a plan of payment. Moreover, a very substantial number of those who attempt a Chapter 13 proceeding fail to confirm or complete a plan. The case for means testing has not been made out.

Section 102 amends Section 707(b) of the Code to presume abuse if a debtor has sufficient income to pay $5,000 over five years to unsecured creditors or to repay at least 25 percent of unsecured claims over the same period. A series of complicated definitions and requirements follow. A debtor may rebut the presumption of abuse by proving "extraordinary circumstances," a heavy burden which entails detailed itemizations and explanations. This provision also permits creditors, presently ineligible, to bring Section 707(b) motions against debtors with higher incomes. If a Section 707(b) motion is successful, counsel for the debtor is required to reimburse the Trustee for costs and attorneys fees where the lawyer's action was not substantially justified. There is also a codification of the language of Bankruptcy Rule 9011 to make it applicable to attorneys for debtors in more situations and subjecting them to civil penalties payable to the Trustee.

This approach to consumer bankruptcy is entirely too severe. There is no discretion in the Court to distinguish between debtors who may be able to make meaningful payments in Chapter 13 form those who deserve to be in Chapter 7. Accordingly, Section 707(b) should simply require the Court to dismiss or convert cases for clear abuse based on the totality of the circumstances. Trustees should be permitted to bring such motions as well as the U.S. Trustee, but not creditors, who would gain too much leverage by such a provision. Bankruptcy Rule 9011 already applies to all attorneys, and codification is unnecessary.

Section 117 applies to Section 362(h) of the Code and eliminates the authorization of punitive damages in appropriate circumstances for violations the stay. This provision also prohibits class actions for violations of the stay. This proposed amendment is not good policy, as there is no justification for limiting the penalties for intentional and flagrant violations of the automatic stay, and it is unwise to restrict class actions in this manner. Moreover, any debtor, not just an individual, injured by a violation of the stay should have a remedy.

Section 121 prohibits the so-called "ride-through" of secured debt in Chapter 7. Where the debtor is not in default in payments under a secured debt contract, the debtor should be able to continue to make payments and to retain the collateral in a Chapter 7 case, a process called ride-through, as this alternative to redemption or reaffirmation appears to work well, and if the debtor subsequently defaults, then the creditor will be able to repossess the collateral.

Section 129 makes changes in Section 1328 of the Code to further erode the "super discharge" of Chapter 13 by excepting our certain debts non-dischargeable in Chapter 7. This is not a good provision. The incentive to complete a confirmed plan in Chapter 13 includes the discharge of many debts that may be non-dischargeable in a Chapter 7. This also tends to eliminate a great deal of non-dischargeability litigation. Congress should not enact provisions that tend to make Chapter 13 less attractive.

Section 149 adds another exception to discharge when the debtor incurs an obligation to pay a non-dischargeable debt intending to discharge in bankruptcy the later obligation, and then goes further to make non-dischargeable debts incurred within 90 days prior to bankruptcy to pay non-dischargeable debts. This provision offends the policy of limiting non-dischargeable debts and caters to the credit card industry. If there is fraud involved, the creditor should be required to prove each element of the misconduct by preponderance of the evidence.

Section 606 requires that a Chapter 13 plan last at least five years unless the debtor's income is less than a designated level. Since most Chapter 13 plans are not completed, it seems unwise to require a longer period of repayment, during which debtors must use up all disposable income.

SMALL BUSINESS PROVISIONS

Sections 401–415 of the Conference Report encompass provisions addressing the so-called small business issues in bankruptcy. The thrust of these sections is to identify quickly small business cases which cannot be reorganized and to push them into chapter 7 and to expedite the processing of those businesses which can be saved with a minium of time and expense. For the most part, these sections work reasonably well but there are serious glitches. I will comment only on those sections which appear to me to require improvement.

In Section 402, the definition of "small business debtor" is limited to those having debts of $4 million or less. I would reduce the debt limit to $2 million, because the higher amount captures too many cases to which the usual chapter 11 procedures should apply. As it is, the lower figure will probably include about 80% of the business filings. In what appears to be a drafting error, the definition seems to include instead of excluding cases in which a creditors' committee has been appointed and is serving.

Sections 404 and 405 provide for reports by the small business debtor. The requirement in the reports of information on profitability should be deleted as impractical and unnecessary in small cases.

Section 406 imposes duties on small business debtors, which in a number of cases may be burdensome and expensive. The Court is allowed to waive these requirements for extraordinary and compelling circumstances. I would charge the test for waiver to that of a more practical standard based on "reasonable justification."

Section 407 sets the filing period for plan as 90 days after the petition in bankruptcy. This period is too short and should be 120 days, and the test for an extension of this period is too difficult and instead, should be a "reasonable likelihood that the debtor will be able to file a plan that the debtor will be able to file a plan that meets the requirement of Section 1129(a)(11) within a reasonable time."

Section 408 sets a deadline for confirmation of small business plans no later than 150 days after the order of relief. I think this would better if the deadline is expressed as 60 days after the time for filing a plan, subject to be shortened or extended by the court on the basis of the same test as set forth in 407 above.

Section 410 describes various duties of the United States Trustee in small business cases and they appear to be mandatory. As a consequence, the U.S. Trustee's office may become overburdened. The U.S. Trustee should be given some flexibility to request and hold meetings with the debtor as may be reasonably necessary to permit the U.S. Trustee to assess compliance with the Code and whether there are grounds for conversion or dismissal of the case.

Section 411 requires the court to hold status conferences in order to expedite the handling of chapter 11 cases. This provision should be limited to small business cases.

Section 412 was apparently designed to withhold application of the automatic stay for a small business that filed a bankruptcy petition within two years after a prior chapter 11 plan had been confirmed or within two years after the dismissal of such a case. The drafting is faulty because the language limits its application to involuntary cases and that hardly seems to be the intended result. Moreover, this provision needs to be redrafted to protect second time filers where the first case was dismissed for immaterial procedural defects and also to soften the showing required for reimposing the stay in other cases.

Section 413 makes substantial changes to Section 1112 of the Code, which sets forth the grounds and procedure for conversion or dismissal. This provision is not restricted to small business cases and the modifications are entirely too draconian. Conversion or dismissal under Section 1112 of the Code should be permissive, not mandatory. "May" should be used instead of "shall." Moreover, the description of cause for dismissal or conversion or appointment of a trustee is probably too detailed and should be reexamined.

TAX PROVISIONS

Section 801 exempts from subordination under Sections 724(b)(2) of the Code *ad valorem* real and personal property tax liens. This Amendment also requires a trustee to exhaust unencumbered assets of the estate and to sur charge collateral under Section 506(c) for expenses of preserving and disposing of such property before subordinating other tax liens. The Amendment also modifies Section 505 of the Code to prevent the Bankruptcy Court from determining the amount or legality of an *ad valorem* tax after expiration of the applicable period for contests under non-bankruptcy law. To the extent that *ad valorem* real property tax liens are exempted from subordination under Section 724(b), this amendment is acceptable. The remainder of the provision is objectionable.

Section 802 sets forth regulations for giving notice to governmental units. This matter is being dealt with in the revisions of the Bankruptcy Rules and should be left out of the Statute.

Section 803 amends Section 505(b) of the Code to require that a request for a determination of tax liability be made in a manner designated by the governmental unit. The principle of this amendment is acceptable provided the address information is published in some central registry so that the parties may comply. The final version of this provision does not provide for a registry and this kind of provision should be carefully circumscribed with respect to state and local taxing authorities.

Section 804 provides a formula for determining interest to be paid on a tax claim where interest is payable, but if the tax claim is an *ad valorem* tax and interest is payable, the rate is determined under applicable non-bankruptcy law. The objective should be to establish a uniform rate, but this provision is deficient in that regard with respect to *ad valorem* tax claims and in some local areas, the rate is quite high.

Section 805 authorizes the tolling of certain time periods in Section 507(a) (8)(A) of the Code, but also adds additional periods of time. The extra time periods are an unnecessary benefit to taxing authorities.

Section 807 again limits chapter 13 super discharge with respect to taxes. It would create an additional reason to avoid chapter 13.

Section 808 carves out of the discharge granted by confirmation of a plan in chapter 11, taxes resulting from the filing of a fraudulent return. This is an unfortunate erosion of the complete discharge provided to a corporate debtor when a chapter 11 plan is confirmed.

Section 809 creates exceptions to the automatic stay for certain appeals in connection with tax proceedings. Exceptions to the automatic stay are generally not favored and this provision is imprecise and will be difficult to apply.

Section 810 regulates the provision for installment payments of tax claims under Section 1129(a)(9)(C) of the Code where a chapter 11 plan is confirmed. The principal objection to this provision is that the deferral period ends when unsecured creditors are paid under the plan so that tax payments could not be deferred if unsecured creditors are paid at the time of confirmation.

MISCELLANEOUS PROVISION

It has been the long standing policy of the Bankruptcy Law to keep in check the number and scope of priority claims and exceptions to discharge or non-dischargeable debts. This policy has the dual purpose of protecting the interests of unsecured creditors, whose distribution is diminished by priority claims, and the fresh start of the debtor, which is certainly affected by non-dischargeable debts. Section 129 (creating additional exceptions to the super discharge in chapter 13), 131, (giving priority status to claims for death or personal injury from drunk driving or drunk boating), and 135 (creating a presumption of non-dischargeability for debts of $250.00 or more for luxury goods) are inconsistent with this policy and should be deleted.

Sections 204 and 1129 should be considered at the same time. They deal with the time periods allowed to perfect a security interest following a transaction. Both are concerned with the preference section in two different aspects an appear to unduly extend these time periods. Section 204 relates to Code Section 547(e)(2). The typical situation involves the closing of a commercial loan following which the secured party must, under state law, promptly file financing statements to perfect his liens. If the secured party waits too long, a gap is created between the funding or borrowing and the perfection of the security interest and thus, the latter represents a transfer for an antecedent debt and is preferential in the event a bankruptcy occurs within 90 days. To protect the secured creditor, a period of 10 days of grace is permitted under the preference section for the filing or perfection of the security interest and this artificially avoids the gap. In multi-state transactions where a large number of filings may have to be made, an argument can be made for extending this period to 20 days, but to extend this period to 30 days would appear to be excessive and an incentive to carelessness among lenders and their lawyers.

Section 1129 amends preference subdivision 547(c)(3)(B), which has to do with the so-called "enabling loan." This is where the creditor makes a loan to enable the borrower to purchase equipment for later delivery and the lien cannot be perfected until the equipment is delivered, at which time it would be preferential should a bankruptcy occur without the benefit of this exception under Section 547. Originally, the creditor was given 10 days to file or perfect the lien after delivery of the equipment. That was extended to 20 days and now the effort is being made to extend this time again to 30 days. A better case may be made out for this change than that under 547(e)(2) because of situations in which the equipment is delivered in parts over a period of time. But, no state has yet to my knowledge increased this period to 30 days and I would be reluctant to do it in the Code without a better demonstration that this charge is necessary.

Section 205 should allow either party to seek an extension.

Section 207 seems unwise. Section 545 of the Code establishes a sound general rule for the validity of common law and statutory liens and to begin to make exceptions smacks of special interest legislation and a bad precedent.

Section 211 broadens entirely too much the availability of the ordinary course of business defense to preference actions under Section 547 of the Code. The double requirement that a transaction be in the ordinary course of business of the debtor and creditor and in accordance with ordinary business terms for the industry, should be retained. The recovery of preferences is the essence of bankruptcy and too many inroads have already been made on this concept. Further exceptions are unwarranted.

Section 213 is too arbitrary in limiting the exclusivity period for filing a plan under chapter 11. The court should have discretion under appropriate circumstances to extend such period, particularly in larger cases.

Section 603 imposes burdensome requirements with respect to notice to a creditor and what would be worse is that a violation of this provision could lead to the debt becoming non-dischargeable.

Section 1101 eliminates the $4 million debt cap in the definition of "single asset real estate" cases. To have no limit is a serious mistake because then the expedited procedure for so-called single asset real estate cases would apply to the large or mega real estate reorganizations and most of them cannot be handled in an expedited fashion. Increasing the debt cap beyond $4 million may have some merit, but there must be some cap. It has been suggested that $15 million would capture most of the cases that should be expedited.

Section 1127 amends Section 363 and 1129(a) of the Code to require that transfers of property of a charitable corporation in bankruptcy must comply with state law. Section 541 of the Code is also amended to require that transfers of property of such corporations to other than a charitable corporation cannot be made except under the same conditions as would apply outside of bankruptcy. These amendments were sponsored solely as a result of one pending case of a number of hospitals in Pennsylvania and are inconsistent with bankruptcy policy. To require the Bankruptcy Court to abide by the diverse laws of 50 states when non-profit corporations seek bankruptcy is contrary to the establishment of a national uniform system. The law already recognizes that property rights in bankruptcy are initially defined by reference to state law, except when there is an overriding federal policy.

Mr. GEKAS. We thank the gentleman, and you can be assured, Mr. Forman, that these communications will be taken into the fullest consideration.

We are continuously groping and grappling with the problem of single-asset issues, as well as some of the reorganization issues upon which the gentleman touched. So we are not without concern about reaching a balanced approach.

The chair will allot itself for 5 minutes for posing a few questions to the panel.

Generally, the discussion by Mr. Mabey and Judge Lee and others have concentrated on how the credit card issuance problem is taking advantage of the poor or at least that the poor are thrust into situations where they have no recourse except for bankruptcy by reason of the extension of credit, and that puts us into a terrible dilemma because we do not want in any way to deprive the poor, do we, of an opportunity to have a TV set or buy some appliance on credit? That is why we have an economy of the type that we have that is based so much on credit.

If we were to take steps to contract the issuance of credit, it seems to me that the first ones who would suffer would be the poor. That is a real dilemma for us. On the one hand, tighten up on the issuance of credit, but make sure that you do not mistreat the poor.

All of a sudden, we have the poor not being able to do anything but to stay poor and not have any of the accoutrements of a better life by reason of the refusal or incapability of extending credit.

Mr. Mabey?

Mr. MABEY. Thank you, Mr. Chairman.

My remarks, as stated and I believe the data show, that if the bankruptcy laws are tightened so as to make credit card lending more profitable, that lending, the new lending will be focused more likely on the poor than it is on others.

Certainly, we should all have credit, and indeed, the history of this country shows that furniture stores were giving a lot of credit back in the 1920's, but I submit that excessive consumer debt is a bad thing. It is a bad thing for the body politic, and it is a bad thing for the soul.

Mr. GEKAS. We do not contest that.

Mr. MABEY. And we ought not use the bankruptcy laws to increase the profitability of this excessive——

Mr. GEKAS. But that sounds like you are saying that our goal is to increase profitability. It is not. It is just wrong to even state a possible conclusion that we are after, trying to increase profitability. We are not, and I want the whole world to know that.

The other part of your presentation that is a little quizzical is that from what we understand, from 1992 to 1995, most of the growth in the credit card indebtedness was attributed to the growth in upper-income indebtedness, not the indebtedness that was thrust upon the poor as in your testimony.

Mr. MABEY. The data I cited were from 1983 to 1992.

Mr. GEKAS. Yes.

Mr. MABEY. And I am informed that if you extend that through 1995, the same trend is established. Certainly, the remarkable fact is that whereas the bottom 45 percent of American households as measured by income, carried only 42 percent of the consumer debt in 1983, by 1992, the bottom 36 percent of American households carried 56 percent of all consumer debt.

I do not have all of the data coming right up to today, but I submit that that is a disturbing trend.

Mr. GEKAS. Another thing, Mr. Shepard, in your presentation, you accented how the bankruptcies that we see running amuck in the country are costly to Government, that they bring about Government costs.

There was something that came up last year which I never really focused on in all my life, and that was when someone goes bankrupt, most often under current law, the taxing authorities, school districts, municipalities, States, and the Federal Government hardly know anything about it. As a result, revenues that they could have expected from a bankrupt, who went bankrupt, have to be borne. The lapse in the collection from those individuals have to be borne by the other taxpayers by reason of increased rates of taxation in those arenas.

Do you concur that that is one of the hidden costs that are attendant?

Mr. SHEPARD. Absolutely. That happens through several ways in the Code that are addressed in 833, and it is essential that those loopholes and those problems be resolved.

Mr. GEKAS. We thank the panel, and we will now allot 5 minutes to the gentleman from New York.

Mr. NADLER. Let me ask Professor King, first of all, if you were an attorney for a sophisticated and wealthy debtor, are there any ways in which you could use this bill as proposed to help a client legally shelter income and assets from creditors?

Mr. KING. Not me, but I think it would be possible.

Mr. NADLER. Could you cite some?

Mr. KING. Well, I think, for one thing, since really the means test, as I understand the bill—and believe me, I cannot say that I fully understand it, which is no fault of the bill—is very complex. It is my own fault, but as I understand it, the means test is basically going to be a comparison between income and expenses. So I think one of the possibilities in terms of planning, if one were to do that, would be to increase expenses, so that there would not be the possibility when a motion was made to show that there was sufficient income over the next 5 years, let's say, to pay whatever may be the set formula.

Mr. NADLER. By the same token, since an extraordinarily large number of debtors do not have attorneys, or lack any assistance beyond simply filling out the schedules, do you think this bill contains traps for the unsophisticated or the unadvised?

Mr. KING. I have a problem as to whether there are more traps for the—well, part of the problem I have is I think there will be more pro se debtors than exists today. If we start from the beginning, what about those who are represented by attorneys? I think more debtors are going to find difficulty in getting attorneys.

I have asked debtors' attorneys, what do you think about this bill, and the common answer I get is a shrug of the shoulders saying they really do not know what they are going to do. Part of the answer is that they may go into another field because it is just too risky for them under the bill to continue as attorneys.

Mr. NADLER. Why is it risky for a practitioner, briefly?

Mr. KING. For one thing, there is an ethics problem because the attorney should be able to advise the client on what is best for the client.

On the other hand, under this bill, the attorney's own pocketbook is at risk because of the dangers. If there should be a motion and if the debtor should lose the motion, the attorney has to pay costs. The attorney may be subject to penalties.

Mr. NADLER. Let me ask the same questions to Mr. Forman. If you are an attorney for a sophisticated and wealthy debtor, are there ways you could use this legislation to legally shelter income and assets from creditors that you cannot now, and by the same token, do you think the bill contains traps for the unsophisticated and unrepresented debtor?

Mr. FORMAN. Yes.

Well, first of all, the bill is so complicated. The provision which deals with the means-testing and needs-testing is difficult even for lawyers to follow, and I would think aside from what Professor King has already pointed out, lawyers are going to be very skittish about this whole situation. As a result, you will have perhaps more pro se filings.

You may also have more pro bono work as we have in Philadelphia. We have a whole community association that represents these people, and there will be an increase of that kind of work as a result of the——

Mr. NADLER. There will be an increase of the necessity for that kind of work, you mean?

Mr. FORMAN. Yes, right.

Mr. NADLER. Let me ask you a different question. Do you think it would be fair to say or not fair to say that this bill is to some extent a get-out-of-debt-free pass for wealthy debtors and a trap for the honest but unfortunate debtor?

Mr. FORMAN. Yes, because what it does is it sets up rather arbitrary tests for moving a debtor from 7 to 13. As a consequence, you are going to find a number of debtors who will not understand what is going on and will suddenly find themselves forced into a situation which they had never bargained for.

A system which targets future income, in my opinion, targets those who are more educated and more skillful because if you were an unskilled person and you go into a bankruptcy proceeding, you are not likely to have much in the way of future income. So you will not meet these tests, and as a result, you will be able to stay in Chapter 7.

Whereas, the plumber, the carpenter, the professional person is likely to have future income, and that person is going to be the one that is targeted by this needs test formula. So it is perverse. You are penalizing somebody who is more educated as a result of his having—pardon me?

Mr. NADLER. I am totally confused by what you just said because I thought that the means test is backward-looking; that is to say, it does not look at your future income, it looks at your past income to see if you passed the means test or not.

Mr. FORMAN. That is right, but the more educated is the one that is going to have more income in the past and more income in the future. So that what you are doing, you are in effect penalizing people who have an opportunity to make a better living than those who do not.

Mr. GEKAS. The gentleman's time has expired.

Does the gentleman from North Carolina wish to be recognized? If so, 5 minutes are granted to him.

Mr. WATT. Thank you, Mr. Chairman.

Let me start by thanking the chairman for having this hearing, as 10 days or 2 weeks ago or so, I was concerned that the chairman was going to treat this as old business and pick up kind of where the subcommittee left off last year and deprive those of us who are new members the opportunity to get our feet on the ground.

I especially was concerned about that because, despite practicing law for 22 years, I have no background in bankruptcy law. So I come to this process to some extent with a clean slate, less dangerous, because I have a long way to go.

I am still concerned that moving this bill to a markup as quickly, apparently as contemplated, will not give me the opportunity to do that and get up to speed, but I think this panel has been extremely helpful.

Not in addressing the merits or lack of merits of the bill that is before us, but for someone like me who is trying to create a basic framework, I want to start with a question that helps me create that basic framework and take advantage of the fact that we have all of these professors here today, in particular.

Professors Posner, Skeel, King, and I guess Judge Lee in particular, and Mr. Forman, too, since he has been around at this for a long time, tell me, if you would, just give me for each one of you the most compelling public policy rationale you believe for even having a bankruptcy provision in our legal system. What is it that historically compels us to have such a thing?

Mr. POSNER. When a large number of people who have borrowed money are not able to repay their debts, often because of health problems and economic downturn, people feel sympathetic for them, as they should, and bankruptcy allows them to keep some of their assets, such as their household furniture, for example, their equity in their house. I think most people probably like the idea that if they borrow a lot of money and they are unable to pay their debts, they would not be stripped of everything they own and be unable to escape these debts for the rest of their life.

On the other side, when you have a generous bankruptcy system, it increases the cost of credit.

Mr. WATT. I am not debating the merits or lack of merits of it. I am just trying to find out what the public policy rationale is, and I hear a sympathy rationale. I presume that is what you were saying.

Mr. SKEEL. I will actually just add a little bit to what Professor Posner said. He talked about bankruptcy from the debtor's perspective.

From the creditor's perspective, bankruptcy is often seen—and one of the other panelists made this point—as a way to coordinate our response to financial trouble. So that instead of having a whole bunch of different creditors, each trying to get assets from the same debtor, bankruptcy is a way to coordinate the response.

Mr. NADLER. So bankruptcy is an organized means of collecting, I take from that.

Professor King?

Mr. KING. I would simply, really, be in agreement with what has been said, from two points of view. One from the debtor's point of view is to provide a fresh start for the debtor who needs it, and that includes not only a consumer debtor. It includes business if a business can reorganize. Without the discharge, a business cannot reorganize. Without a discharge, a consumer debtor cannot get a fresh financial start, a new financial life, and from the creditor's side, the basic policy consideration is that of equitable distribution of assets available for distribution to unsecured creditors in a collective proceeding rather than in a race to the courthouse and a piecemeal-type distribution.

Mr. WATT. It looks like my time is going to run out. Would you allow the other two gentlemen, if they have answers that are different?

I have sympathy, an organized system of getting creditors lined up to claim, and a fresh start as the three things I have heard up to this point. Any different ones?

Mr. LEE. Well, I think bankruptcy is an alternative to debtors prison. We started out in this country putting debtors in prison for debt, and, of course, that cost the taxpayers money, also. They had to pay for the upkeep of the prisoners. So I think society may suffer a little cost from bankruptcy, but if given an opportunity, I can pretty well dispel the notion that bankruptcy costs creditors and families cost families $550 a year.

Mr. WATT. I do not want to get there yet, and I do not have time to get there yet.

Mr. Forman?

Mr. FORMAN. I think most of the ideas have already been expressed. I would just expand a little bit on what Professor King said about the fresh start.

Instead of being oppressed with debt, not only do you get a fresh start, but you become a productive member of society again, and you are able to become a customer again and to make purchases. You become a better credit risk after a discharge than you were before.

So it is a societal benefit to have a bankruptcy system. I do not think there is any doubt about that.

Mr. GEKAS. The time of the gentleman has expired.

Mr. WATT. Mr. Chairman, are you contemplating going a second round, or what is your protocol?

Mr. GEKAS. No, I had not. I wanted to coincide the conclusion of this panel with the advent of lunch.

Mr. DELAHUNT. Mr. Chairman, it is my time.

Mr. GEKAS. The gentleman from Massachusetts is recognized for 5 minutes.

Mr. DELAHUNT. In response to the comment about lunch, we have seven witnesses here. I dare say that if the gentleman wants a second round it would behoove the chair to allow a second round.

Mr. GEKAS. I have nothing against a second round. I am simply saying that whatever we do, we want to finish before the advent of lunch, whether it be stomach problems or time problems.

The gentleman from Massachusetts is recognized for 5 minutes.

Mr. DELAHUNT. Thank you, Mr. Chairman.

My understanding is that the proponents of the legislation have two objectives. One is to reduce consumer debt, and probably the over-arching one is to reduce bankruptcy filings.

In your opinion, is this legislation going to accomplish that? You are experts. I would like to hear from the experts, if you could just give us a simple yes or no, because we would like to get you on record.

Mr. Shepard?

Mr. LEE. I would like to answer. Can I answer that?

Mr. DELAHUNT. Sure. I am going to let each one of you answer that, Judge Lee.

Mr. LEE. I think you need to look at the Canadian experience which I mentioned in my paper, and in Canada, they have suspended discharges for quite a number of years, patterned on the English system.

Canada also has deregulated interest since before the 1900's, back in the 1800's. They had deregulated interest. They did not have a problem with bankruptcies until about 1968, and that is when Visa entered Canada and started sending credit cards and signing up businesses for credit cards and disbursing credit cards. Almost immediately, the bankruptcy rate in Canada jumped 340 percent.

Mr. DELAHUNT. Let me interrupt, and I appreciate your response, but I am really trying to get everybody on record.

I presume that your answer would be that without considering credit card lending practices, we will not see a reduction in bankruptcy filings or a diminution of consumer debt. Am I stating your position accurately?

Mr. LEE. Yes.

Mr. DELAHUNT. Thank you.

Now if I can start with Mr. Shepard, and again, we will have a second round, but we are really pressed for time. We have got to get to lunch.

Mr. SHEPARD.. Thank you.

I do believe it will reduce filings. Keep in mind that this is not solely dealing with the credit card——

Mr. DELAHUNT. So you say it will reduce filings?

Mr. SHEPARD. I do.

Mr. DELAHUNT. In terms of consumer debt, which many of us are concerned about—I think we all share that opinion on the committee in terms of the escalating numbers—do you think consumer debt will slow down?

Mr. SHEPARD. I think the ultimate effect will be that there will be a reduction in consumer debt.

Mr. DELAHUNT. Thank you.

Professor Posner?

Mr. POSNER. It will probably reduce filings slightly, since the means test applies only to people who make more than $51,000 or so.

Mr. DELAHUNT. So probably reduce?

Mr. POSNER. Yes, unless, of course, something like a recession occurs and other factors.

Mr. DELAHUNT. Well, okay, and as far as consumer debt is concerned?

Mr. POSNER. It is impossible, I think, to make a prediction.

Mr. DELAHUNT. Impossible to make a prediction.

Professor Skeel?

Mr. SKEEL. My answer would be similar. On filings, I think it might reduce filings, at least somewhat.

Mr. DELAHUNT. Significantly? Substantially? A little bit?

Mr. SKEEL. A fair amount, more than—I cannot testify more than that.

Mr. DELAHUNT. A fair amount, okay.

Mr. SKEEL. Whether or not it will be substantial, I cannot say.

Mr. DELAHUNT. You cannot say whether it is going to be substantial.

Mr. SKEEL. On debt, I think it is also likely to reduce debt, subject to the same caveat. If there is some extraordinarily economic event that we are not anticipating, that may change things.

Mr. DELAHUNT. Okay.

Professor King?

Mr. KING. I think bankruptcy is a conclusion or a result that is not a cause. I do not think it will have anything to do with reducing or increasing consumer debt. It might increase it by making it more profitable, as Mr. Mabey was saying.

With respect to filings, I would say that under this bill, it is possible to decrease filings for all the wrong reasons, simply because

Chapter 7 will not be available, Chapter 13 is terrible, and my question would be where do all these people go.

Mr. DELAHUNT. Mr. Mabey?

Mr. MABEY. Thank you.

I submit that it will increase consumer debt. In 1984, when the law was tightened, Business Week's article was titled "Consumer Lenders Love the New Bankruptcy Law," and said, "Lenders say they will make more unsecured loans from now on, trying to lure back the generally younger and lower-income borrowers recently turned away."

Mr. DELAHUNT. Judge Lee, we have heard from you.

Mr. Forman?

Mr. FORMAN. I concur in what has been said on the subject. There is no sense repeating it. There is nothing more.

Mr. DELAHUNT. We want your opinion, Mr. Forman.

Mr. FORMAN. Well, I would doubt very much that there will be any decrease in filings. I think if bankruptcy is indicated, they are going to file, and I do not know that there is anything in here that is going to stop it.

As far as consumer debt is concerned, unless we have a recession, I think consumer debt is going to increase.

Mr. DELAHUNT. Thank you.

Mr. GEKAS. Does the gentleman wish to pose any other questions in lieu of a second round?

Mr. DELAHUNT. I would like to have a second round, Mr. Chairman.

Mr. GEKAS. Does the gentleman wish to pursue any line of questions now in lieu of a second round?

Mr. DELAHUNT. No. I would prefer to have a second round, Mr. Chairman, because I want to respect and defer to my——

Mr. GEKAS. Do you want to have a second round at the lunch counter?

Mr. DELAHUNT. We can have lunch brought in, Mr. Chairman.

Mr. GEKAS. Sonny Bono is not with us any longer. He used to do that for us, I remember.

The gentleman from North Carolina is recognized for whatever question he wishes to pose.

Mr. WATT. I thank the chairman. I did not mean to get us into a tug-of-war either about a second round or about lunch, but I did have a couple of things that I am trying to get reconciled.

This relates to Professor King's comments and Mr. Shepard's comments. Professor King, if I heard him correctly, indicated that historically there had been a lot of discretion in the bankruptcy system for judges to really manage and deal with issues.

Mr. Shepard seemed to be suggesting that greater clarity in the law was absolutely necessary to remove some of the discretion that judges have, and I confess, having worked in the judicial system, I have been on both sides of that issue myself, whether a judge ought to have more discretion or less discretion, but I would always assume that in the bankruptcy system, judges ought to have more discretion to kick out people who are abusing the system and keep people in who are not abusing the system.

How do you reconcile those two things, or am I misinterpreting the two issues here? Did I misstate where you were on this issue?

Mr. SHEPARD. No. I think you have accurately described it.

The thing that is necessary is consistency and predictability, and if we have bright lines that are visible to the public and they can understand what the rules are, we will have consistency and predictability.

Mr. WATT. That brings me to my next question because Judge Randall Newsome, who is going to testify either on a subsequent panel today or tomorrow, one of the real concerns he has expressed in his testimony is about the number of vague terms that exist in this particular bill.

It seems to me that that cuts absolutely against what you are saying. You would want more precise wording in terms. The more vague the standard, the more discretion, it seems to me, you are giving judges. Is that not correct?

Mr. SHEPARD. Not necessarily.

What I am suggesting is that we need the bright lines. We need consistency, and we need less discretion.

Mr. WATT. Do you like this bill, or do you not like it?

Mr. SHEPARD. I like the bill.

Mr. WATT. Okay. So how is a judge going to decide, for example, on this issue of monthly expenses? This bill states the debtor's monthly expenses shall be the applicable monthly expenses under the national standards, local standards, and other necessary expenses allowance, excluding payments for debts issued by the Internal Revenue Service.

So, instead of having a law that articulates it, now we are going to have the Internal Revenue Service articulating what the standard is which is very troubling to me. It would seem to me to grant more discretion to a judge to interpret what the Internal Revenue Service is saying in this area.

Mr. SHEPARD. The problem is now the law does not provide the guidance. It does not provide the guidelines, and under 707(b), which is very ineffective, it is just total discretion as to whether or not there is an abuse there.

Mr. WATT. So you are not saying this is necessarily good. You are just saying it is better than what we have now, which is nothing.

Mr. SHEPARD. I am saying it is good in the sense that if you look a little further, there are published guidelines that can be used, and it does not require, then, some mysterious magic to come up with the numbers.

Mr. WATT. Professor King, what do you say to this dispute that we are having—this discussion we are having here? It is not a dispute.

Mr. KING. First of all, let me put it this way. I do not think that it is possible to conclude whether there should be more discretion or less discretion. I think that it is necessary to look at each particular provision and determine with respect to that provision whether there should be some discretion in the court or there should be a bright-line test. That is where the difficulty comes in, but there are certain times when there should be a bright-line test, as there is with respect to some things, and in other things, there should be discretion in the court because the cases are different, the facts are different.

Mr. WATT. Do you think this is a bright-line test?

Mr. KING. I do not think it is. I do not know what kind of a test it is. If I were a judge, I do not know what I would do.

Mr. WATT. I think it is chaos, it sounds to me. Maybe it is just because I do not understand it.

Mr. KING. I doubt that is the reason. I think it may be un-understandable.

It is not that it is so un-understandable. The problem is how do you apply it. What is a judge going to do? What is a judge going to look at? How many alternatives does a judge have to look at? If Judge A says one thing, there is no reason why Judge B could not say something completely different from that, in an almost similar set of facts.

Mr. GEKAS. The time of the second round of the gentleman has expired.

Mr. WATT. I thank the chairman for his indulgence. As you can see, I am really wrestling with some of these issues.

Mr. GEKAS. We are going to try to provide you more information on the needs test provision.

Mr. WATT. Could I just ask Professor King one short question? Do you like this bill, or you do not like it?

Mr. KING. I do not like the bill.

Mr. WATT. All right. Thank you.

Mr. GEKAS. Does the gentleman from Massachusetts wish to pose any more questions? If he does, it is up to him.

Mr. DELAHUNT. Well, I thank the chair, and I will.

Mr. GEKAS. Now, the third round will take place——

Mr. DELAHUNT. That is after lunch, Mr. Chairman, I presume.

Mr. GEKAS [continuing]. At dessert time.

Mr. DELAHUNT. Much has been stated. I think it was Judge Lee who talked about $550 per American taxpayer, and during the course of time, we hear that we are paying this through increased interest rates, particularly credit card rates.

Just again, a quick review—if this bill should pass, as it is presently drafted, in your opinion, will interest rates go down? Again, you know how pressed I am for time. So, if you can, make your answers very short.

Mr. SHEPARD. I think the interest rates are tied too closely to whatever the Federal Reserve does.

In terms of the cost of bankruptcy going down, definitely, because——

Mr. DELAHUNT. Not the cost of bankruptcy. Credit card interest rates, will they go down, Mr. Shepard? Yes? No? Maybe?

Mr. SHEPARD. What I am saying is taxes and other things, cost of goods, those things have to go down. The direct interest rates, I believe it is fixed more by the Federal Reserve system than the bankruptcy——

Mr. DELAHUNT. So you do not think that this bill will have an impact on interest rates, one way or another?

Mr. SHEPARD. I do not think so. I think it is a function of the bank.

Mr. DELAHUNT. Thank you.

Professor Posner?

Mr. POSNER. I agree.

Mr. DELAHUNT. It will not affect rates one way or another?

Mr. POSNER. It is unpredictable what the impact would be, and I think probably unlikely that it would have an impact.

Mr. DELAHUNT. Thank you.

Professor Skeel?

Mr. SKEEL. I would ditto that.

Mr. DELAHUNT. Professor King?

Mr. KING. I do not think they would go down.

Mr. DELAHUNT. You do not think they would go down.

Mr. Mabey?

Mr. MABEY. From 1980 to 1985, credit card interest rates went up from 17.3 percent to 18.7 percent, while the Treasury bill rates went down from 10.75 percent to 7.76 percent. The reason this happened is because the credit card lenders began lending more to poorer people, and in order to keep their margins up, the credit card interest rates stayed up.

Also, I think there is not much sensitivity among consumers to credit card rates after they get the initial——

Mr. DELAHUNT. So your answer is they will not go down. Am I stating that fairly, Mr. Mabey?

Mr. MABEY. My answer——

Mr. DELAHUNT. They may go up?

Mr. MABEY. It is Mr. "Mabey," actually.

Mr. DELAHUNT. Mr. "Mabey." Thank you.

Mr. MABEY. I have to just insert that my grandfather was Governor of Utah in 1920, but was defeated for reelection by George Dern on the slogan, "We want a Dern good Governor, and we do not mean Mabey." [Laughter.]

Mr. DELAHUNT. Mr. Mabey, was it your grandfather?

Mr. MABEY. Yes, sir.

Mr. DELAHUNT. Was your grand daddy a Republican, or was he a Democrat?

Mr. MABEY. Like me, he was a Republican.

Mr. DELAHUNT. Thank you, Mr. Mabey.

Judge Lee?

Mr. LEE. I do not believe interest rates will go down because if you realize that half of the credit card debt has already been securitized or sold to trusts in which other banks have invested and those trusts are committed to make a reasonable return to those investors, sometimes as much as 7 percent over the period during which the trust is in effect. It just seems impossible that those interest rates could go down.

Mr. DELAHUNT. Thank you.

And, Mr. Forman?

Mr. FORMAN. I do not believe interest rates will go down at all, and by the way, it was Judge Mabey. He was a very distinguished judge at one time.

Mr. DELAHUNT. Well, he is a very distinguished witness, but I think what we have achieved here, for the first time, is unanimity, at least on this particular issue. The entire panel agrees that if this legislation should pass, interest rates will not be affected, and I thank you, Mr. Chairman.

Mr. WATT. Would the gentleman yield?

Mr. DELAHUNT. I will yield to my friend from North Carolina.

Mr. WATT. You have got about a millisecond left, and I feel like I have discriminated against Mr. Mabey by skipping over him all the way through this process, and I am not asking this question because of that. It is a sincere question.

I have been a very, very strong advocate for increasing the availability of credit to working people and poor people. I have also been a very, very strong advocate for holding lenders accountable and making them more responsible. Am I just schizophrenic? Are those two things irreconcilable? We are kind of making it sound like they are.

Mr. MABEY. In a free market, I believe the more profitable lending is, the more lending that will occur, and certainly, credit card lending has proved to be the most profitable segment of the banking industry.

Insofar as consumers are less able to file bankruptcy, lending should become more profitable, and credit card lending would then increase.

I do not think increasing consumer debt from a moral or a business standpoint is a good idea, but I agree with you that there should be sufficient lending capability there, particularly for the poorer Americans who need it.

I would ask Congress—well, that is presumptuous. I would hope that one ght look at additional warnings on credit cards, perhaps take a look at the usury laws which were destroyed. It may take a recession to bring us back in balance. I hope not.

In the end, how much money we borrow on our credit cards is probably taught at our mother's and father's knee, and I am not sure how much this panel will have an impact on that.

Mr. FORMAN. What we may need, Congressman, is a national usury law that is stricter to replace what the Supreme Court has done in the Marquette case.

Mr. WATT. Could I ask one more question?

Mr. GEKAS. The time of the gentleman——

Mr. WATT. Mr. Chairman, you have been very generous.

Mr. GEKAS. You may proceed.

Mr. WATT. I hear you, Mr. Forman, but isn't part of the thing that we shifted the cost of credit with interest rates?

I mean, I like the convenience of getting something and not paying for it for 60 days and not having an interest charged to me for 60 days, but somebody is paying for that—30 days. I am sorry. There is no credit card out there—but somebody is paying for my ability to carry that debt or have the credit card company carry that debt for 30 days.

I am one of those people who is religious at least until this past month in paying off all credit card debt within that 30-day period, but somebody out there is paying a higher interest rate because I got that 30-day grace period.

It may be—I am not proposing this. So, bankers, do not fall out of your chair. Credit card companies, do not fall out of your chair, but it may be just as rational to have a slightly higher usury rate if the usury rate ought to be 16 percent, maybe make it 18 percent, but also have some requirement that the people who are carrying this debt for that 30-day period pay their part of it.

You say I am paying part of it, anyway. Society is paying part of it, anyway. Why not make the people who are actually using it pay their part of it? I do not mean to get too philosophical here, Mr. Chairman, but these are very difficult issues, it seems to me.

Mr. LEE. Can I respond? When the credit card bank buys an account from the provider, the merchant or the provider of services, they buy it at a discount of 2 to 3 percent, and they do make money as a result of that. I do not know that they are hurt much for that 30-day delay in payment.

They do get some percentage of interest, which has to be added on to the other 18 percent that they get. So we are talking about 21 sometimes, 20 or 21.

Mr. GEKAS. The time of the gentleman has again expired, and I think the patience of the chair has expired. Therefore, this panel has expired, and we thank you from the bottom of our heart, seriously. You have added to the discourse that is necessary to presage the enactment of any bankruptcy reform. We thank you.

We now will recess until 1:45, at which time we will ask the next panel to be poised for their presentations. We stand in recess.

[Recess.]

Mr. GEKAS. The recess has been concluded, and we are prepared to entertain the next panel. If they would approach the witness table, we can begin.

The first individual to be introduced is James Smith, president and chief executive officer of the Union State Bank and Trust of Clinton, Missouri. He is also vice chairman and director of Exchange National Bank Shares, Inc., in Jefferson City, Missouri.

Mr. Smith began his career in the banking industry in 1967 with the Boatman's Union National Bank in Springfield, Missouri.

Before entering the banking industry, Mr. Smith was a professional baseball players with the New York Yankees from 1963 through 1966. He holds a bachelor of science degree in business from Southwest Missouri State University.

Mr. Smith has previously testified before this subcommittee on bankruptcy reform, and we welcome him here today.

One of my favorite witnesses of all time—I say that because she is a constituent, and I do not want to be misunderstood—is Janet Kubica, who has been active in the credit union industry since 1975. She has served as a volunteer board member and supervisory committee member of other credit unions.

She is a member of the Credit Union Founders Club for chartering new credit unions, and has worked as a consultant for the Pennsylvania Credit Union League.

Since 1988, Ms. Kubica has served as president and chief executive officer of Postmark Credit Union, a not-for-profit cooperative financial institution. The members of Postmark Credit Union are primarily employees of the United States Postal Service and their families.

Ms. Kubica currently is a board member of the Harrisburg Chapter of Credit Unions and serves on the Regulatory Review Committee of the Pennsylvania Credit Union League.

She attended the University of Pittsburgh and lives in Harrisburg, Pennsylvania.

Ms. Kubica has testified previously in the forum that we have provided for our efforts on bankruptcy reform, and we welcome her here today.

Frank Torres, III, has areas of expertise including banking and financial services, electronic commerce, consumer credit, mortgage lending policies, and electronic transfer of funds.

He has previously testified before Congress on issues relating to bank mergers and financial services regulatory reform. He has also lectured extensively on these subjects.

Before joining Consumers Union in 1997, Mr. Torres was the director of the Governor of Guam's Washington Liaison Office.

Mr. Torres received his bachelor of science degree in 1985 from Georgetown University. He thereafter received his juris doctorate degree in 1990 from George Washington University School of Law.

As we have always intoned in these hearings, the written testimony of the witnesses will be accepted for the record without objection, and each will be given up to 5 minutes and more, if really required, for their oral presentation.

Mr. Smith?

STATEMENT OF JAMES E. SMITH, PRESIDENT AND CEO, UNION STATE BANK AND TRUST, CLINTON, MO, ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION

Mr. SMITH. Thank you.

Chairman Gekas and members of the subcommittee, I am pleased to be here today on behalf of the ABA to discuss bankruptcy reform.

Bankers well understand the anxiety caused by financial problems. We want to work with troubled borrowers to help them avoid bankruptcy.

Unfortunately, however, a growing number of people are choosing to file for bankruptcy, rather than trying to work out their problems.

The current system allows these individuals to wipe their debt slates clean, even though they can afford to repay at least some of their obligation.

The time has come to fix our bankruptcy laws. Bankruptcy protection should be provided only as a last resort, and only for people who really need it.

Today's system costs every American household more than $400 per year, and this amount will certainly grow if there is no fix.

Adding new judges to deal with the ever-growing caseload will also cost taxpayers millions.

There are three reasons why H.R. 833 should be enacted. First, the record number of personal bankruptcies at a time when our economy is healthy is a clear sign that our bankruptcy system is broken.

Second, H.R. 833 strikes the right balance. It keeps a safety net for the vast majority of filers, while putting those individuals who can repay a portion of their debt on a repayment plan.

Third, H.R. 833 vastly improves the collection of alimony and child support payments in bankruptcy proceedings.

Mr. Chairman, almost 1.4 million people declared bankruptcy in 1998, about 1 in every 70 households. This record level was set in a year when the economy was strong and unemployment was the lowest in nearly 3 decades. Clearly, consumer bankruptcies are disconnected from economic conditions. The system must be fixed now.

Let me give you one example of how rising bankruptcies affect my bank and my borrowers. We are very active in making micro loans to low-income individuals. These loans are often as low as 2- or $300. Even though these loans are small, bankruptcy losses on just a few of these loans may make the micro program not worth offering.

More troubling are stealth bankruptcies in which borrowers show excellent credit histories right up to the day they file. Let me give you two examples.

The first was a borrower who bought a brand-new Dodge truck 3 weeks before declaring bankruptcy. It was a year before he had to turn in the now used and abused truck.

The second was a rancher who borrowed to buy 50 head of cows and calves. He sold the animals in 30 days, declared bankruptcy, and walked away with all the money.

The fundamental flaw in today's system is the complete discretion to choose Chapter 7 over Chapter 13, regardless of the borrower's ability to repay. Chapter 7 offers complete relief from all unsecured debt. So it is not surprising that 7 out of 10 choose it.

Bankruptcy should provide individuals with the amount of relief they need, no more and no less. The needs-based approach in H.R. 833 accomplishes that goal.

Individuals with incomes below the prescribed level retain the option to file in Chapter 7. For others, the amount of financial relief is determined by a simple formula based on income and obligations.

This system would prevent abuse and send a strong message that bankruptcy is not a first resort for the financially reckless. Yet, it would maintain the full Chapter 7 safety net for those debtors who need such total relief.

Mr. Chairman, my written statement also addresses the commercial provisions of H.R. 833. We endorse some, and we express strong concern about others. And as we will discuss on Thursday, we do not believe Chapter 12 should be made permanent without reforms to prevent abuse, nor should its scope be expanded beyond small family farmers.

We appreciate the subcommittee's interest in this issue. The record created here can help to build momentum for overdue reforms.

Thank you.

[The prepared statement of Mr. Smith follows:]

PREPARED STATEMENT OF JAMES E. SMITH, PRESIDENT AND CEO, UNION STATE BANK AND TRUST, CLINTON, MO, ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION

Chairman Gekas and members of the Subcommittee, my name is James E. Smith. I am President and CEO of Union State Bank and Trust, in Clinton, Missouri. I am immediate past Chairman of the American Bankers Association's Government Relations Council. I am pleased to be here today on behalf of the ABA. The ABA brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership—which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks—makes ABA the largest banking trade association in the country.

Mr. Chairman, I would like to thank you for your leadership on the issue of bankruptcy reform. Given record numbers of bankruptcy filings and their inevitable impact on both lenders and borrowers, these hearings are very timely. ABA strongly supports near-term enactment of H.R. 833, which would create a means-tested approach to consumer bankruptcy, and make many necessary improvements in commercial bankruptcy law. H.R. 833 is an effective and bipartisan response to current problems in the bankruptcy system.

I would like to first discuss the very important improvements this bill makes in the consumer area. The fact is that our consumer bankruptcy system is in serious trouble. We believe that a needs-based approach is the best way to achieve an appropriate balance between providing relief for debtors who truly need it and preventing abuse of the system by those who have the capacity to repay at least a portion of their debt.

Under current law, bankruptcy is too often used as the first resort, rather than the last resort. By taking advantage of flaws in the current system, individuals can wipe their debt-slates clean even though they have the capacity to repay all or a portion of their obligations. Moreover, there is ample evidence that a small but growing minority of borrowers is abusing the credit system by taking loans with no real intent to repay.

H.R. 833 also proposes some important improvements in commercial bankruptcy law. For example, it will create a simplified framework for small business bankruptcies. It will also end abusive single asset real estate bankruptcies by lifting entirely the debt cap on cases subject to expedited Code provisions. It facilitates the completion of "prepackaged" Chapter 11s. At long last, it limits repetitive judicial extensions of the exclusivity period in Chapter 11. It provides a beneficial framework for the resolution of cross-border bankruptcies. And it includes important resolution of the treatment of swaps, derivatives, and other financial instruments when a counterparty becomes insolvent, which will enhance the safety and soundness of the financial system.

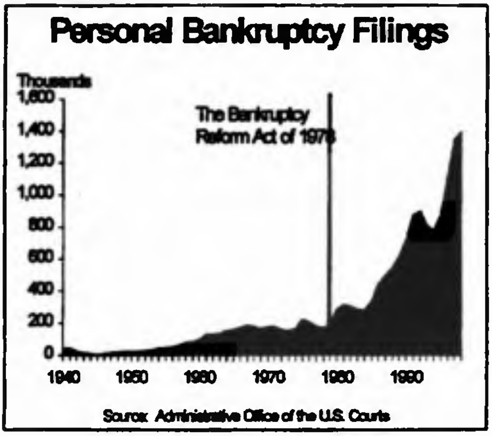
I would like to make three main points in my statement today.

- The record number of personal bankruptcies—occurring at a time when our economy is very healthy—is a clear sign that our consumer bankruptcy system is broken. While the situation today does not pose a safety and soundness problem for banks or thrifts, it is important to recognize that rising bankruptcies will inevitably have an impact on the cost and availability of consumer credit which in turn will negatively affect overall economic growth.
- A *needs-based system* as proposed in H.R. 833 balances the twin goals of debtor relief and creditor recovery. The fundamental flaw in the current consumer bankruptcy system is that debtors are permitted complete discretion as to whether they will enter into a Chapter 7 liquidation plan or a Chapter 13 repayment plan. A needs-based approach would send a strong message that bankruptcy should be a last resort for troubled borrowers.
- While commercial bankruptcy filings have diminished due to strong economic conditions, certain reforms would be desirable. In particular, we recommend the following: expedited treatment of small business reorganizations; assuring that all single asset realty cases are resolved quickly and fairly; preventing endless extensions of Chapter 11; and, if Chapter 12 is made permanent, assuring a quick and fair resolution for lenders.

Before turning to a discussion of these points, let me reiterate our support for the reforms proposed in H.R. 833. This bill effectively addresses the serious flaws in current law, especially in the consumer area where the problems are the most severe.

CONSUMER BANKRUPTCY

Mr. Chairman, the final numbers are now in on personal bankruptcies for 1998, and they once again set a new record. About 1.38 million people declared bankruptcy—a 3.2 percent increase over the 1997 level. This means that *one in every seventy U.S. households filed for bankruptcy in 1998*. What is equally stunning is that this record was set in a year where Gross Domestic Product hit new highs and the unemployment rate was at historic lows. Personal bankruptcies have nearly doubled so far this decade, up 94.7 percent since 1990. Clearly, consumer bankruptcies are increasingly disconnected from the general state of the economy and suggest to us that underlying causes are likely rooted in today's flawed bankruptcy laws.



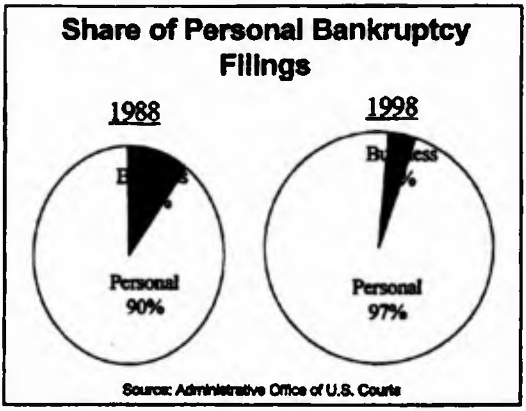
The impact of the change in consumer bankruptcy law in 1978 is clearly demonstrated on the adjacent chart. Following passage of the Bankruptcy Reform Act of 1978, there has been a dramatic rise in the incidence of personal bankruptcy filings. The Bankruptcy Code currently contains many flaws which both encourage unnecessary filings and lead to abuse. These flaws include, first and foremost, the lack of any effective and uniform screening standards to determine whether a debtor truly needs Chapter 7 liquidation or has the financial ability to fund a meaningful Chapter 13 plan. Chapter 13s have a standard length of only three years, while most consumer loans today are for longer terms or entirely open-ended. Debtors find it too easy to "load up" on debt in contemplation of filing and to then discharge it, even where it has been used to satisfy nondischargeable obligations. The amount owed on valuable collateral such as autos can be crammed down just weeks after purchase. Debts acquired through fraud can nonetheless be discharged in a Chapter 13 case. Creditors operate under a statutory "gag order" which prevent them from bringing evidence of abuse to the court's attention. And serial filings can endlessly forestall repossessions and other actions within creditors' rights when there is no intention to go through with the bankruptcy; while serial bankruptcies are available to discharge a debtor's responsibilities every half dozen years.

These and other defects in current law and practice have led to today's bankruptcy reality an overloaded court system giving assembly line treatment to a record number of bankruptcy cases, many of which receive excessive or undeserved relief based on unsubstantiated claims

Approximately 97 percent of the filings in 1998 were non-business bankruptcies. This is quite different from the experience of the 1980s. For example, from 1980 to 1987, consumer filings ranged between 82 to 86 percent of total filings. In 1988, personal bankruptcies grew to 89.6 percent of total filings, and the percentage has risen every year since then.

Today's consumer bankruptcy crisis poses no imminent danger to the safety and soundness of the financial system. Banks and other lenders have tightened underwriting standards and reviewed pricing in light of current conditions, and they have ample capital and reserves.

But the fact that there is no immediate danger does not mean that there is no reason for concern. At some point, without bankruptcy reform, lenders will dramatically tighten lending standards, a move that will have consequences for the overall economy.



For example, my bank is very active in making small "micro" loans to low income individuals. These loans are often as low as $200–$300 dollars. Given this small loan size, we cannot afford to do expensive background checks. Rather, these are truly "character" loans. The rise in personal bankruptcies has forced us to re-evaluate these types of loans, however. Even though the loans are not large, it does not take too many losses to make this entire line of micro loans not worth offering.

The same process of reconsideration is likely to occur for many other banks in all kinds of consumer loans. Simply put, a tightening of underwriting standards means either the price of credit rises, or less credit is offered or both. In my case, it may determine whether a whole line of credit products will be eliminated—something that would be sad for my bank and my community.

Perhaps even more troubling is what I call "stealth bankruptcies" in which borrowers show excellent credit histories right up to the day they file and wipe out their lenders. Those borrowers look just like many others who never file bankruptcy. There are two examples from my community that I would like to share with your Subcommittee, Mr. Chairman. The first was a case where a borrower bought a brand new Dodge truck three weeks before declaring bankruptcy. It was nearly a year before he had to turn the now used and abused truck back in to the lender. The second was a case of a rancher who borrowed to buy 50 head of cows and calves. He sold the animals in 30 days, declared bankruptcy and walked away with all the money.

Clearly, these are severe abuses of the system. There are many more examples of borrowers who have chosen bankruptcy as a first resort, rather than trying other available alternatives such as working out revised payments with lenders or availing themselves of consumer credit counseling assistance. Let me share a few stories I have heard from bankers across the country.

- A banker from New York says that a lawyer in his area is advising clients to pay their nondischargeable debt with credit card cash advances, and then file Chapter 7. The credit card balances, which are unsecured debt, can then be discharged.
- A New Mexico banker made a loan to an employed individual secured by an automobile in 1995. The individual declared Chapter 13 after having made only six payments over 14 months. Only one loan payment was made under the Chapter 13 repayment plan, and the bankruptcy trustee subsequently dismissed the plan. But when the bank repossessed the car, they were told the individual had filed another Chapter 13—so the bank had to return the car. The bottom line is that the individual still has a good job and still has the car—and the bank is out $21,000.
- A banker from Ohio reports that a customer borrowed money to buy two automobiles, then literally disassembled the cars, sold the parts, and declared bankruptcy.
- A banker from Texas tells of a couple who took out a SBA loan to start a business. When the business did not do well, the bank tried to work with them to develop an appropriate course of action. Rather than working with the bank, however, they filed Chapter 7. They had good income from other

jobs, owned a mortgage-free residence (which was protected under the bankruptcy law), and had virtually no other debt—in other words, they had the ability to repay all or some of the loan. The bank lost over $12,000.

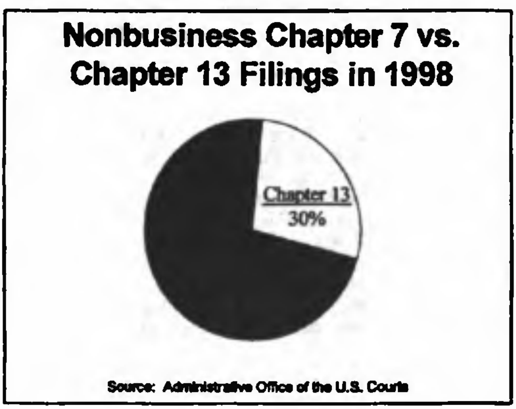
CONSUMERS HAVE COMPLETE DISCRETION FOR CHOOSING CHAPTER 7 OVER CHAPTER 13

These stories point out that there are very serious flaws in the current consumer Bankruptcy Code. Perhaps the most fundamental flaw is that filers are allowed total discretion over whether they should file in Chapter 7 or Chapter 13, regardless of ability to repay. In Chapter 7, repayment is based on assets. Filers must either reaffirm their secured debts by acknowledging post-bankruptcy personal responsibility to pay them, redeem their secured debts by making full payment, or surrender their collateral. Unsecured lenders receive payment, if any, out of the bankruptcy trustee's liquidation of debtor property which exceeds applicable exemption levels (which are mostly set by state law). Nineteen out of twenty Chapter 7 filings are "no asset" cases in which there is no nonexempt property to liquidate and unsecured lenders lose 100 cents on the dollar. Chapter 7 cases constitute about seventy percent of all non-business filings.

In Chapter 13, repayment to creditors is based on income. The debtor agrees to a repayment plan with a three-to-five year duration. Home mortgage lenders are repaid according to the original payment schedule, other secured lenders are assured of full repayment of the portion of their loan which is collateralized, and unsecured lenders receive repayment based on remaining disposable income.

An individual filing in Chapter 7 may be directed to Chapter 13 under present law when the judge determines that a Chapter 7 discharge would constitute "substantial abuse." However, such instances are rare. This is due to the assembly line, overloaded nature of the consumer bankruptcy system and the lack of economic incentives for the trustee to undertake an in-depth inquiry into most cases. In addition, *current law prevents those who most likely have information regarding debtor abuses—the lenders—from bringing it to the attention of the court.*

Chapter 7 bankruptcy is a highly unusual legal process. In other civil cases one seeking an injunction to bar legal actions must generally demonstrate the imminent threat of irreparable harm as well as a high probability of succeeding on the merits. But in the current system, the *mere filing* of a bankruptcy petition provides an automatic stay, which halts all foreclosures, garnishments, and other legal proceedings against the debtor. In addition, while the law is what we look to for contract enforcement, in bankruptcy the law cancels or rewrites contracts to relieve debtors of their obligation to perform on their contractual promise to pay. These are extraordinarily potent legal powers. They may be necessary to accomplish the renewal function of bankruptcy, but providing them to virtually anyone just for the asking clearly opens up the bankruptcy system to abuse.



Chapter 13 also has been abused by individuals under the current system. Many who file in Chapter 13 never complete their full repayment plan—a fact some critics cite to question the enforceability of a needs-based bankruptcy system. But the real issue here is the ability of these individuals to use Chapter 13 simply to cure mortgage defaults, with no intention to complete their plan; they later file a "Chapter 20" bankruptcy by converting to Chapter 7 and wiping out unsecured lenders. In other words, current law permits debtors to obtain many of the benefits of Chapter 13 without carrying out their repayment responsibilities.

The high proportion of Chapter 7 cases regardless of repayment ability and the rapidly growing number of consumer bankruptcy filings together constitute a significant long-term threat to the availability of reasonably priced credit to U.S. consumers. The "bankruptcy tax", the cost of bankruptcies which is ultimately passed on to other borrowers, is already in excess of $400 per U.S. household. This does not include the cost of the bankruptcy court system that has been overwhelmed by the record high filings. Adding new judges to handle the growing case load will cost taxpayers millions of dollars more. These unfair taxes on responsible borrowers will likely escalate without Congressional action.

H.R. 833 BALANCES THE TWIN GOALS OF DEBTOR RELIEF AND CREDITOR RECOVERY

Administrative Needs-Based Approach to Consumer Bankruptcy

Adoption of an administrative needs-based policy would best achieve the appropriate balance between debtor relief and creditor recovery. We are gratified by the bipartisan consensus that fundamental reforms are needed in the consumer bankruptcy process, and that the heart of these reforms is a needs-based bankruptcy system. Such a system would recognize that consumer bankruptcy, like every other part of the social safety net, should have safeguards to prevent abuse of its most generous benefits. It would also send a strong message that bankruptcy can no longer be regarded as an easy first resort for the financially reckless.

Needs-based bankruptcy reserves complete liquidation of unsecured debts for those borrowers who really need complete debt forgiveness. It is a system that prevents individuals with substantial disposable income from manipulating the bankruptcy system to avoid their repayment obligations if they have the resources to repay all or a part of what they owe.

An administrative needs-based approach is simple and straightforward. First, for those individuals with incomes below a prescribed level, there would always be the option to file in Chapter 7. Second, for those individuals with higher than the prescribed income level, there would be a simple formula to calculate how much an individual can afford to repay based on income and obligations. For example, the clerk of the court or bankruptcy trustee would review the information in the debtor's petition to determine income, deduct the portion required to meet household expenses and pay secured debts and unsecured priority debts, and then calculate how much remains, if any, for the payment of unsecured non-priority debts. If the amount available to pay that latter category of debt exceeds a certain percentage over the normal time span of a Chapter 13 plan, the debtor would be denied eligibility for Chapter 7.

The Bankruptcy Commission recommended taking a purely judicial approach to determine eligibility for filing in Chapter 7. We are convinced that the administrative approach outlined above is more efficient and more fair. An administrative system provides uniform and predictable results based upon clear and objective standards. It does not require additional expenditures to have counsel argue a motion before a judge with an overcrowded calendar. And it gives clear notice to debtors, prior to filing, of exactly the extent of relief they can expect to obtain if they file for bankruptcy.

It is important to note that needs-based bankruptcy does not prevent debtors from obtaining substantial relief under the Federal bankruptcy laws. Those who cannot repay their debts would continue to be eligible for complete relief under Chapter 7. Furthermore, under a needs-based system, debtors still may file a Chapter 13 petition (or, in rare cases for high-income individuals, Chapter 11) and obtain the injunctive relief of the automatic stay. Chapter 13 provides avenues for curing defaults and restructuring payments on secured debts which are not available in Chapter 7, and it provides a broader bankruptcy discharge upon completion of the repayment plan. And debtors still can void their legal responsibility to pay a substantial portion of their unsecured debts. But they cannot avoid all repayment obligations when they have the disposable income to make good on a significant portion of what they owe unsecured creditors.

H.R. 833 contains the blended system combining administrative and judicial elements which was agreed upon by Conferees last fall. It requires a motion under Section 707(b) of the Code, with its filing by the Chapter 7 trustee being mandated for debtors above median income who can pay either 25 % of unsecured debts or $5,000 over a five year repayment plan. Debtors could only overcome the presumption of abuse under this formula by demonstrating truly "extraordinary circumstances". This approach is, frankly, neither as efficient or as uniform as the administrative approach which was adopted by this Committee and the House last year. Nonetheless, it represents a very substantial improvement over the present consumer bankruptcy system because it effectively incorporates the principle of means-testing Chapter 7 relief.

Other Important Reforms to Consumer Bankruptcy Law Contained in H.R. 833

H.R. 833 also proposes other important reforms in consumer bankruptcy law which ABA strongly supports. For example:

- establishing that significant consumer debts incurred within 90 days prior to filing for bankruptcy should be presumed nondischargeable;
- barring the discharge of fraudulently obtained debt in all consumer bankruptcy cases;
- establishing auditing and documentation requirements for debtor filings, and providing for legal actions if material misstatements are submitted;
- barring Chapter 7 refiling for 8 years after discharge, and setting a limit (5 years) for the first time on Chapter 13 refilings;
- permitting lenders to bring evidence of abuse to the court's attention;
- permitting lenders to be represented by non-attorneys at the initial meeting with the debtor;
- directing the bankruptcy courts to compile and publish new statistical data on filings;
- expediting the initiation of Chapter 13 payments and assuring adequate protection payments in the interim;
- establishing 5 years as the normal length of a Chapter 13 plan for those debtors with above median income;
- clarifying that debtors lose the benefit of the cramdown of under-secured debts when they convert from Chapter 13 to 7, ending "Chapter 20" abuses;
- establishing that collateral securing a note cannot be subject to cramdown in any bankruptcy filed within 5 years;
- requiring that debtors generally first try to resolve their difficulties through credit counseling, and generally requiring debtors to complete a financial management training program as a condition of the discharge;
- quadrupling, to two years, the length of time a debtor must reside in a state to take advantage of its homestead exemption;
- subjecting debtor's attorneys to sanctions for abusive petitions and motions; and
- establishing a "debtor's bill of rights" to provide debtors with a description of their legal rights and options and what services should be provided by those preparing their filing.

H.R. 833 also contains extensive new provisions to assure that bankruptcy can no longer be used as a device to avoid the payment of alimony, child support, and other familial obligations. In particular, child support is made the first priority among all unsecured debts; debtors must continue to pay child support after filing; and a discharge will not be granted until child support payments are brought current. We applaud these provisions. The lending industry supports all reasonable steps to assure that children and spouses are paid first before other creditors.

We do have reservations about certain provisions of H.R. 833 which arose in the Conference Report on H.R. 3150. The requirement that a debtor waive in writing a court hearing on a valid reaffirmation agreement is a step backward from the elimination of this burden on the courts that was made by the 1994 Reform Act; in any event, if this change is adopted, there is no justification for exempting debts owed to credit unions. New Truth in Lending Act disclosures regarding minimum payments on open-end credit and requiring representative examples of payoff times can be accommodated, but earlier proposals for account-specific calculations would not only be a data processing nightmare but could well mislead consumers. And the requirement that credit card companies not terminate account holders solely because they do not incur finance charges is far preferable to earlier proposals that would have legislated the pricing structure for this product.

COMMERCIAL BANKRUPTCY

Business bankruptcies now constitute less than five percent of all bankruptcy filings, indicating that there is no business bankruptcy crisis. However, there are some reforms that could improve the operation and effectiveness of Chapter 11's framework for business reorganizations. In particular, Chapter 11 does not work very well for small businesses. One of the Bankruptcy Commission's better recommendations was for the creation of a less complex and expedited Chapter 11 process for small businesses. That proposal would encompass 85 percent of all Chapter 11 filings. We are pleased that H.R. 833 includes a workable version of this proposal. It will help ensure that small businesses have the best possible chance of successfully reorganizing by taking advantage of a system which is less complex and expensive.

We are anxious to see the removal of the $4 million debt cap that unwisely limits the effectiveness of the action taken by Congress in 1994 to curb abusive single asset realty bankruptcies. Again, H.R. 833 accomplishes this important goal.

Another key reform would be to set some firmer limits on a judge's ability to approve repeated extensions of the exclusivity period in Chapter 11s. This is the time span during which only the debtor-in-position may propose a plan of reorganization. Chapter 11 was meant to be a way station in which companies could adopt and implement a plan to rejoin the economic mainstream; it was not meant to be a semi-permanent state of existence which coddles existing management. At some point certain, other parties in interest to a case should have the right to step forward and propose their own reorganization plan for a vote, if the debtor has been unable or unwilling to do so. H.R. 833 sets a firm limit on such extensions at 20 months past the initial six-month period. While this still may be too generous, at least companies will no longer be permitted to operate in bankruptcy beyond that period without ever adopting a reorganization plan.

H.R. 833's provisions addressing the status of financial instruments in bankruptcy will add desirable stability to the financial system. Generally, instruments such as swaps and derivatives would not be included in "property of the estate" and would therefore be immune from creditor seizure. The netting of various types of exposure under "master netting agreements" would also be recognized.

In our interconnected world, cross-border insolvencies involving multiple jurisdictions are increasingly common. H.R. 833 would facilitate their orderly handling by establishing new rules on venue and other key considerations.

We are, however, compelled to raise serious concerns about some of H.R. 833's commercial provisions.

The most offensive is a provision which was obtained by shopping center interests. It would compel their tenants in reorganization to affirm or reject their leases within 120 days after filing. This imposes an impossible deadline for major retailers operating from dozens or even hundreds of locations. Have no doubt, this alteration will make it far more likely that troubled retailers will fail to reorganize and that the jobs associated with them, both directly and at their many suppliers, will be jeopardized. This provision is also patently unfair to the broad spectrum of their unsecured lenders—not just banks, but suppliers, professionals, and workers. When a commercial real estate lease is assumed under coercion the entire unexpired portion of the lease becomes an administrative expense priority if the reorganization fails. We have no objection to a landlord being paid for the time the space is actually occupied, but there can be no justification for paying them for the lease term after abandonment to the economic detriment of all these other parties. This provision must be addressed and rewritten to provide retailers with a reasonable period in which to decide where to continue operations, and to provide fair treatment to all unsecured creditors.

Another provision provides trade creditors with an additional 25 days in which to file reclamation claims for return of their goods. We have no objection to this procedural improvement. However, at the same time you address this matter you should add a technical correction to the 1994 Reform Act to clarify that a debtor's ability to voluntarily return goods is subject to any liens or other security interests that apply to them. In addition, you should oppose any attempt to make the reclamation rights of an unsecured creditor superior to the rights of a secured lender holding a lien on those goods. Certain trade creditors are pressing for such a change. It would completely undermine the legal basis of secured lending and threaten the availability of one half trillion dollars' worth of secured credit extended to U.S. businesses each year. ABA would forcefully oppose such a threat to this critical commercial lending activity.

We are also concerned about the provision which would allow the judge open-ended discretion to arbitrarily and unilaterally change the makeup of the creditors' committee. This would usurp the role of the U.S. Trustee, cause undue delay, and increase costs. It could also lead to the failure of reorganization attempts if the insertion of "vulture" investors on the committee leads to acrimonious conflict. Any new authority for the court to alter these committees should be narrowly circumscribed.

Finally, we would ask you to consider the addition of language clarifying that a judge may auction assets of a company in Chapter 11 in the absence of a reorganization plan. While this is the practice in some courts, others believe that statutory authority is required.

You should also be aware that during your consideration of H.R. 833, the Supreme Court is expected to issue its decision regarding whether or not the "new value exception" is a part of the Code. We may well urge you to respond to that decision if the Court causes damage to the absolute priority rule.

FARM BANKRUPTCY

H.R. 833 would make Chapter 12 a permanent part of the Bankruptcy Code. Chapter 12 was passed in 1986 in response to the greatest agricultural debt crisis since the 1920's. Because it was an emergency response to a crisis, the original act was set to sunset in October, 1993. In 1993 Chapter 12 was extended, with little modification, to October 1998. As you %90 know, Congress extended it by six months last October, and it appears that you are about to give it yet another six months of existence.

Since Chapter 12 was enacted, the agricultural economy has improved greatly. Agricultural asset values and farm incomes have rebounded or exceeded the levels they reached in the early 1980's. After an initial surge of filings, Chapter 12 filings have declined significantly. While we would prefer to see Chapter 12 expire as Congress intended, we believe that, at a minimum, its permanent adoption should be accompanied by some fundamental reforms to address ongoing problems.

First, discipline must be restored to reaffirm the original goal that Chapter 12 be an *expedited* resolution of farmer debts. The primary reason for creating Chapter 12 was that the existing bankruptcy chapters were too expensive and too time consuming for farmers to be able to effectively use to reorganize their businesses. Because of the crisis atmosphere that surrounded the legislation, Congress acted to make sure that any farmers that could quickly reorganize would be able to do so. Today a fanner under Chapter 12 protection has 90 days to file a reorganization plan after the order for relief has been filed. The debtor is supposed to be allowed extensions by the court only in cases where the debtor should not be "justly" held accountable. In practice, the courts have been far too willing to grant repeated extensions in Chapter 12 cases without adequate justification required by the code. We believe that extensions should be limited to a maximum of 60 days, and that debtors be given a maximum of 150 days to file a plan before claim holders can initiate liquidation actions.

Second, excessive cramdowns of secured claims are often granted on the basis of unduly low appraisals provided by the debtor. In Chapter 12, lenders that have their claims crammed down to the value of the collateral lose any opportunity to recover the value of their claim in the future if the debtor defaults on the plan, or if the debtor chooses to sell. In Chapter 11 (business bankruptcy), lenders may make an election that allows them to recover unsecured claims if the debtor defaults on the plan or sells the business. Under this election in Chapter 11, a debtor that successfully completes the plan will receive all of the benefits of the court ordered cram down. Only if the debtor defaults or voluntarily sells will the lender have the opportunity to try to recover the full value of the claim. A similar provision in Chapter 12 would create a powerful incentive for the debtor to successfully complete the plan, and would provide for equitable treatment of lenders in case of a default or voluntary sale.

Finally, we are adamantly opposed to the provisions of H.R. 763. That bill would double the debt limit for Chapter 12 eligibility, taking Chapter 12 far beyond the small family enterprises it was intended to help. It would also grant the special protections of Chapter 12 to individuals who had not fanned for up to three years. We urge you to reject that proposal.

CONCLUSION

Mr. Chairman, the ABA appreciates this opportunity to address you on bankruptcy issues. We think it would be a terrible mistake to ignore what the record levels of personal bankruptcies are telling us—namely, that the current system is broken and must be fixed. We believe that H.R. 833 is a good approach to reform of the system. It would establish a bankruptcy system which provides appropriate debtor protection while also preventing abusive use of the system by individuals who have the capacity to repay all or a portion of their debts.

We appreciate your and the Subcommittee's interest in this issue, and we look forward to working with you and other Judiciary Committee members to ensure that bankruptcy reform is enacted in this Congress.

Mr. GEKAS. We thank the gentleman.

I wish we had time to discuss the history of Joe DiMaggio, my baseball hero back in those good old days, but we will do that privately sometime.

Ms. Kubica?

STATEMENT OF JANET KUBICA, PRESIDENT AND CEO, POSTMARK CREDIT UNION, HARRISBURG, PA, ON BEHALF OF THE CREDIT UNION NATIONAL ASSOCIATION

Ms. KUBICA. Good afternoon, Chairman Gekas and members of the subcommittee. I am Janet Kubica, president of Postmark Credit Union in Harrisburg, Pennsylvania.

I very much appreciate the opportunity to tell you about our concerns with the increasing number of bankruptcies and how this is impacting credit unions.

I am speaking on behalf of the Credit Union National Association, CUNA, which represents over 11,000 State and Federal credit unions nationwide.

Postmark Credit Union——

Mr. GEKAS. Pull the microphone closer to you, please.

Ms. KUBICA. Postmark Credit Union is a $24.5-million State-chartered federally insured credit union. Along with other creditors, credit unions are experiencing an increase in bankruptcy filings, with almost half of all credit union losses due to bankruptcy.

Postmark has experienced an increase in Chapter 7 bankruptcy filings, which caused the greatest loss to the credit union. Credit unions clearly recognize the value of financial counseling for their members, such as a consumer credit counseling service.

However, even with financial counseling, we certainly recognize that bankruptcy may be the only alternative for some members a way to get a needed fresh start.

Credit unions want to help their members avoid financial difficulty through learning to manage their credit. More emphasis should be placed on consumer financial education so people can learn how to manage credit and what the alternatives to bankruptcy are.

Therefore, CUNA strongly supports the provisions in H.R. 833 requiring the debtor to receive credit counseling prior to filing for bankruptcy, and that requires a consumer debtor to be given a notice about bankruptcy and a description of credit counseling services.

We support the sense of Congress in H.R. 833 that each of the States should develop curriculum on personal finance for elementary and secondary schools.

During the 1997–1998 school year, credit union volunteers visited classrooms across the country to educate students about the wise use of credit, savings options, budgeting and careers.

I have provided the committee members with copies of the CUNA publication, "Savingteen." This highlights financial literacy and youth. I would ask that this publication be submitted for the record.

Mr. GEKAS. Without objection, it will be included in the record.

[The information was previously submitted at the oversight hearing on Bankruptcy Reform held on March 11, 1999.]

Ms. KUBICA. Thank you.

For various new initiatives, CUNA is developing an even more aggressive strategy to promote consumer financial education.

Credit unions believe that reaffirmations are a benefit both to the credit union and to the member. By reaffirming with the credit union, the members continue to have access to financial services and reasonably priced credit.

We are aware of cases of abusive credit practices, but the current Bankruptcy Code caught the violators. The size of the penalties imposed will act as a deterrent to others. The ability of credit unions to enter into reaffirmation agreements with their members is so important that if reaffirmations were severely limited, CUNA would strongly oppose bankruptcy reform legislation, regardless of what the rest of the bill might contain.

Reaffirmations can be vital to the credit union member. For example, a couple who are long-time members of our credit union filed for bankruptcy. They reaffirmed their credit card debt with the credit union so they could continue to have access to reasonably priced credit.

Recently, they applied for a new car loan. Because they were making timely payments on the credit union, we approved their loan, and it was at the same rate as we offer it to other members. The couple now are making timely payments on both loans.

Because credit unions are very anxious to see Congress enact meaningful bankruptcy reform, CUNA supports the needs-based provision in H.R. 833 as the best opportunity to achieve this important public policy goal.

Credit unions believe that consumers who have the ability to repay all or some of their debts should be required to file a Chapter 13, rather than have all their debt erased in a Chapter 7.

We also support the random audit requirement in the bill as an additional effort to ensure that debtors provide accurate schedules and documentation of income so that those who can repay some part of their debts will be required to do so in Chapter 13.

In conclusion, let me say that I am pleased you are holding this hearing today on H.R. 833, and we encourage Congress to push for passage of bankruptcy reform as soon as possible.

I will be happy to answer any questions.

[The prepared statement of Ms. Kubica follows:]

PREPARED STATEMENT OF JANET KUBICA, PRESIDENT AND CEO, POSTMARK CREDIT UNION, HARRISBURG, PA, ON BEHALF OF THE CREDIT UNION NATIONAL ASSOCIATION

Good morning, Chairman Gekas and other members of this subcommittee. I am Janet Kubica, president of POSTMARK Credit Union in Harrisburg, Pennsylvania, and I appreciate the opportunity to be here to tell you about our concerns with the increasing number of bankruptcies and how this is impacting credit unions—and my credit union in particular. I am speaking on behalf of the Credit Union National Association (CUNA), which represents over 11,000 state and federal credit unions nationwide. We are very pleased that this subcommittee is holding hearings today on bankruptcy reform legislation, H.R. 833

POSTMARK is a $24.5 million state-chartered, federally-insured credit union. Its 4300 members are primarily U.S. Postal Service workers and their families in the Harrisburg area. Currently we have almost $14.5 million in loans to our members—that's over $6 million in car loans, more than $5 million in home-secured loans, and almost $2 million in personal loans. In addition, we have issued about 1,000 credit cards for another $1 million.

Nationwide bankruptcy filings exceeded 1.4 million in 1998, which was a 2.7 percent increase from the 1997 filings. In fact, bankruptcy filings have set records in 1996, 1997, and 1998. And it is not anticipated that there will be a decrease to these high numbers for 1999. Consumer bankruptcy filings made up 96.9 percent of those 1998 filings. Credit unions are quite concerned about this steady increase in bankruptcy filings nationwide in the last few years because they have seen a similar increase in the number of credit union members who file. Preliminary data from credit union call reports to the National Credit Union Administration (NCUA) show that credit unions had approximately 253,000 filings in 1998, which is an increase to the 250,000 filings in 1997. The 1997 figures were an increase of 20% over 1996 levels, and the 1996 filings were 35% higher than the 1995 figures. CUNA estimates that almost half of all credit union losses in 1998 were bankruptcy-related and that those losses reached $684 million.

In Pennsylvania credit unions are experiencing record highs in bankruptcy filings—they have tripled in the last five years and the 1998 total topped 7,300. Since 1994 the annual increases for bankruptcy filings at credit unions have averaged 24%. While the number of filings is historically high, the rate of filings is also unprecedented—in 1994 the total filings per thousand credit union members was .86, while in 1998 it was 2.30 filings per thousand members.

At POSTMARK bankruptcy filings and losses have shown a steady increase since 1994. In 1994 we had 7 members who filed for bankruptcy, in 1995 there was dip to 3, in 1996 it rose again to 9, reached 16 in 1997, and hit 15 in 1998. A significant number of our bankruptcies are chapter 7, which cause the greatest loss to the credit union.

As the number of member bankruptcies has increased, so too have the losses to the credit union. Our losses in 1994 due to bankruptcy were only $2,923, but in 1997 these losses had increased to $65,720—an increase of over 2000%. In 1998 the losses fell to $20,652. This information on the number of bankruptcy filings and on the credit union's bankruptcy losses is attached to my testimony.

POSTMARK is a careful lender. We cannot afford to be otherwise. We do a good job with scrutinizing loan applications and carefully determining that the applicant is creditworthy before extending credit. We examine credit reports, verify income, and see that a reasonable debt-to-income ratio is maintained by the borrower. We even look at the applicant's disposable income to determine that the applicant can make the payments. We routinely monitor our credit cards and do not make any across the board increases to the credit limit. Students can apply for a credit card, but we encourage a co-signer and set the credit limit at no more than $500.

In an effort to combat the number of bankruptcies at the credit union, POSTMARK has tightened its credit policies. As I said, we do annual reviews of our signature lines of credit, and during our annual review in 1998 we carefully did not reissue the cards to certain members. After making a check of credit reports, we did not reissue cards to those members who were overextended or had a poor repayment history with the credit union.

If a member is experiencing financial problems and mentions bankruptcy to us, we immediately notify staff who are trained in credit counseling to contact that member and let the member know that the credit union is there to help them through the financial difficulty. We started doing this because otherwise the member may file for bankruptcy even in cases where there is an ability to repay. When a member files for bankruptcy, we attend the 341 hearing, where creditors are permitted to question the debtor.

CREDIT UNIONS SUPPORT FINANCIAL EDUCATION

Credit unions clearly recognize the value of financial counseling for their members. According to a recent CUNA bankruptcy survey, 70% of credit unions counsel financially troubled members at the credit union. A similar percentage of credit unions may also refer members to an outside financial counseling organization, such as the Consumer Credit Counseling Service (CCCS), and many do both. At POSTMARK we refer those members who are experiencing financial difficulties to the local CCCS and have found that beneficial for the members and their families. We also try to educate our members about alternatives to bankruptcy. We offer credit counseling to all our members at any time and encourage them to come to the credit union for help if they are experiencing financial difficulties. We tell the members about this service in our newsletter and other publications.

However, even with financial counseling, we certainly recognize that there are some instances in which bankruptcy may be the only alternative for members, the way for them to get the needed "fresh start."

Credit unions want to help their members avoid financial difficulty through learning to manage their credit. We believe that more emphasis should be placed on consumer financial education so people can learn how to manage credit and what the alternatives to bankruptcy are. The CUNA Bankruptcy Subcommittee recently reported that "[e]ducation was found as one of the most promising strategies to consider in attempting to reverse the trends in bankruptcy." Credit unions have found that educating their members about credit and how to use it can be an effective deterrent to filing for bankruptcy.

Therefore, CUNA strongly supports the provision in H.R. 833, the House bankruptcy reform legislation, that requires the debtor to receive credit counseling prior to filing for bankruptcy and prohibits the chapter 7 or 13 debtor from receiving a discharge if the debtor does not complete a course in personal financial responsibility. Recognizing that consumers need to know more about alternatives to bankruptcy so they can make a more informed decision, we also support the provision in the bill that requires a consumer debtor to be given a notice about bankruptcy and a description of services from trustee-approved credit counseling services. Any sensible bankruptcy reform should include education provisions to give debtors the tools they need to make wise decisions about filing for bankruptcy and to succeed financially after bankruptcy.

In addition, credit unions recognize that financial education needs to be made available early on and before consumers experience financial problems. Therefore, we support the sense of Congress that each of the states should develop curriculum on personal finance for elementary and secondary schools. Credit unions are currently going into their local schools and teaching students about money management. In addition, the National Youth Involvement Board (NYIB), a national network of credit union volunteer professionals, helps credit unions to educate young members. During the 1997-1998 school year more than 5,000 credit union speakers visited classrooms across the country, and as a result, more than 110,000 students heard about the wise use of credit, savings options, budgeting, and careers.

Many credit unions also devote office space for consumer libraries that enable members to use a wide range of financial periodicals, manuals, and books to learn more about money management and to research buying decisions, retirement plans, and a host of other issues relating to personal finance. And, through various new initiatives, CUNA is developing an even more aggressive strategy to promote consumer financial education.

CREDIT UNIONS SUPPORT REAFFIRMATIONS AS A BENEFIT BOTH TO THE MEMBER AND TO THE CREDIT UNION

Because we are a not-for profit cooperative financial institution, losses to the credit union have a direct impact on the entire membership due to a potential increase to loan rates or decrease in interest on savings accounts. Therefore, we have a policy that if a member causes a loss to the credit union, services to that member, aside from maintaining a share account, will be withheld. Most credit union members take this seriously and continue to reaffirm on their credit union loans. However, we are beginning to see that some members do not care if they cause a loss and are denied service because they believe they can get it elsewhere—even though it may be at a higher rate. We continue to see more "surprise" bankruptcies, where the member is a long-time member and is current on his or her debt at the time the bankruptcy petition is received.

Credit unions believe that reaffirmations are a benefit both to the credit union, which does not suffer a loss, and to the member, who by reaffirming with the credit union continues to have access to financial services and to reasonably priced credit. We are aware of concerns of abusive creditor practices, recently highlighted in high profile press coverage, but note that the current Bankruptcy Code, in fact, caught the violators. The size of the penalties imposed will undoubtedly act as a deterrent to others. The ability of credit unions to enter into reaffirmation agreements with their members is so important that if reaffirmations were severely limited or made not usable, CUNA would strongly oppose bankruptcy reform legislation regardless of what the rest of the bill might contain.

As I said, reaffirmations are very important to credit unions, and they can be vital to the credit union member. For example, a married couple, who are long-time members of the credit union, get into financial difficulties and ultimately file for bankruptcy. They reaffirmed their credit card debt with the credit union so they could continue to have access to reasonably priced future credit. Later they came back to the credit union with an application for a new auto loan. Because they had been making timely payments on their credit card, we did approve the car loan—at the same rate as we offer it to all our members. And, these members have continued to make timely payments on both loans—the credit card and the new car.

CREDIT UNIONS SUPPORT NEEDS-BASED BANKRUPTCY

Credit unions are very anxious to see Congress enact meaningful bankruptcy reform and believe that "needs-based bankruptcy" presents the best opportunity to achieve this important public policy goal. Credit unions believe that consumers who have the ability to repay all or some part of their debts should be required to file a chapter 13, rather than have all their debt erased in chapter 7. Therefore, CUNA supports the needs-based provision that is contained in H.R. 833. This provision was a compromise developed out of the bankruptcy reform bills that received overwhelming support in the 105th Congress.

Let me tell you about two cases that illustrate why needs-based bankruptcy and its provisions are needed. In one case, a working couple, who are credit union members, filed a chapter 13 in November 1996. However, they did not show on their schedule that one of them was earning significant overtime. They even denied any overtime during a sworn deposition—even though the subpoenaed payroll records showed overtime and a joint monthly income of $4,500. These members owed $30,000 of unsecured and secured debt to the credit union. An unsecured amount of $14,000 was discharged, and the secured vehicle was crammed down to $13,000 in the plan. The debtors only made a few payments through the plan and then stopped. The trustee dismissed the case. We started to repossess the car, but were then notified that the debtors are refiling bankruptcy. So, two and a half years have passed, the car is depreciating, the balance on the car loan is almost $10,000, and it will be quite some time before we see another payment.

In another case, again we challenged a plan where we believed the debtor could make more payments, and we did ultimately obtain a favorable decision from the judge. However, we still have not received any payments from the plan. Our attorney fees for these two cases are over $12,000—and yet the credit union still has not received any payment from one debtor's plan and only a few payments from the other. Challenging a debtor's plan can be costly and delay payment from the plan. This is a reason why we support the provision in H.R. 833 that the debtor provide accurate schedules with tax returns, pay stubs, and other proof of income. Certainly that overtime would have been shown on the pay stub! In addition, we support the random audit provision which would ensure that the debtor does provide accurate documentation of income and thus, those who can repay some part of their debts would be required to do so.

Again, let me say that I am pleased you are holding this hearing today. Credit unions are very anxious to see Congress enact meaningful bankruptcy reform and believe that "needs-based bankruptcy" presents the best opportunity to achieve this important public policy goal. The 105th Congress strongly supported needs-based bankruptcy, and CUNA supported these efforts. These hearing that are being held on H.R. 833 show that the 106th Congress is continuing to move toward passage of bankruptcy reform legislation. We encourage Congress to push for passage of this reform before Congress' fall recess.

Thank you for the opportunity to testify today before the committee on CUNA's support for H.R. 833. I will be happy to answer any questions.

FACT SHEET
POSTMARK CREDIT UNION
HARRISBURG, PENNSYLVANIA

Total Assets: $24.5 million
Members: 4,300
Total Loans: $14.5 million

Losses Due to Bankruptcy:

1998: $20,652.00
1997: $65,720.00
1996: $25,693.00
1995: $13,572.00
1994: $2,923.00

Number of Filings:	*Chapter 7*	*Chapter 13*	*Total*
1998:	9	6	15
1997:	11	5	16
1996:	7	2	9
1995:	1	2	3
1994:	4	3	7

Mr. GEKAS. We thank the lady, and we turn to Mr. Torres for 5 minutes.

STATEMENT OF FRANK TORRES, LEGISLATIVE COUNSEL, CONSUMERS UNION, WASHINGTON, DC

Mr. TORRES. Thank you, Mr. Chairman.

Mr. Chairman, members of the committee, thank you for the opportunity to be here today to discuss this very important issue.

Consumers Union, together with a whole host of other groups, are very much concerned about the impact these bankruptcy reform proposals will have on hard-working Americans.

Just because more American families are filing bankruptcy does not mean that they are abusing the system, and what we truly have here is a debt problem in this country, something that will not necessarily go away, even if this bankruptcy reform proposal or another bankruptcy reform proposal is enacted. We truly need to get at this debt problem.

The credit industry has to take some responsibility in fueling it. Giving credit to people who cannot repay does not help anyone. It does not help the economy. It does not help other working families, and it certainly does not help the industry.

I just heard this morning on the radio that a new Federal Board report is coming out showing that about 42 to 45 percent of banks' income are coming from fees, and there was an industry analyst from Goldman Sachs who was very much concerned about this because for him what it mean was to get these fees, there has to be a much more aggressive marketing to riskier people who before were not extended credit and who may not understand what it is all about, the elderly lower income and students and minors. It is kind of a vicious cycle.

Banks need to raise the profits to help their shareholders. So it is a race to the bottom to make it all happen. Yet, at the same time, these practices, as the Goldman Sachs analyst said this morning, also helps to drive customers away.

How did we get to this? Anything that we can do to help stem this helps everyone, not just the creditors, but the debtors as well.

So what can we do in the context of the bankruptcy reform bill? One way is to help consumers understand the terms and conditions of the credit which they are being offered. This is not restrictive. We are not talking about anything restrictive here, but we are talking about giving people the tools up front, not once they are in trouble, but up front so that they can properly determine what is best for them.

First, enhance disclosures to consumers about the consequences of making minimum payments by providing true amortization information on the bill. It is fair. It is easy. It is something that passed overwhelmingly in the Senate bill, and you should seriously consider including it in any bankruptcy reform proposal that comes through the house.

Oprah has had people on. A credit union ad played up the fact that you have got to really read the fine print. People do not understand some of the terms, and people certainly do not understand what it is if they buy a $30 dress at the Gap that they might end up paying $36 for it at the end of the day. Shopping for a bargain is not really shopping for a bargain if you are paying a lot of interest for it.

Second, ensure that no credit cards are provided to minors unless there is a demonstrated ability to repay or when a parent or other adult co-signs.

Take a look at this ad for a credit marketing conference. It is entitled, "Targeting Teens. You Never Forget Your First Card." Most teens never forget their first love, nor do they forget the issuer who dares to accept their application. Their brand loyalty and propensity to spend make consumers in their mid to late teens prize prospects for many card issuers. Any education effort certainly has a lot to conquer if they are trying to combat that type of thing.

Next, there should not be any penalties or card cancellations for consumers who pay the balance in full owed on a card in any month.

We hear stories about consumers who are getting nickel-and-dimed by fees or who are trying to be responsible in paying down their debt. Why penalize them if the whole idea, at least my understanding of it, was to help consumers be more responsible?

Fourth, require full disclosure of security interests on credit card purchases that could lead to further threats of repossessions of household items.

And there are some other issues that I think we need to discuss.

We heard testimony last week that a primary reason that people file for bankruptcy is the practice of debt collectors. If there is an interest in stemming bankruptcies, maybe we should do something about that.

Second, the credit industry needs to take some responsibility for removing the stigma of bankruptcy as it no longer shuns people who file or who have bad credit but actively solicits their business, and some ads were pointed out this morning.

Also, I know we have gotten new information that shows fewer people who are filing for bankruptcy can actually repay, and I believe there are some experts that will be in tomorrow.

Fourth, not all people are benefiting from these good economic times. The Economic Policy Institute published a report earlier this year called "The State of Working America." It found that the typical family is worse off at the end of this decade than it was at the end of the 1980's. It said 86 percent of the benefits of the stock market between 1989 and 1997 actually went to the wealthiest top 10 percent of households, that young families start off at lower incomes, that actually the gains in this good economic times are corporate profits, the stock market, and executive pay. So I think we need to get some more better information about this.

Finally, there has been a lot of talk about the cost of bankruptcy for each American family, leading people to believe that if the bill passes, we should all expect a check for $550 in our mailboxes. At a minimum, the credit industry should be reducing the interest rate on the credit card, yet there is nothing in the bill that requires any cost savings be passed on to consumers.

Mr. Chairman, I appreciated your comments earlier saying you were going to look at different aspects of the bill to make it better, and I certainly would be willing to continue to work with you and your staff in helping to resolve some of these issues.

[The prepared statement of Mr. Torres follows:]

PREPARED STATEMENT OF FRANK TORRES, LEGISLATIVE COUNSEL, CONSUMERS UNION, WASHINGTON, DC

Chairman Gekas, Members of the Committee, my name is Frank Torres and I am Legislative Counsel in the Washington office of Consumers Union, the not-for-profit publisher of *Consumer Reports* magazine. Thank you for this opportunity to speak you about bankruptcy reform, and in particular ways to give consumers the opportunity to better understand the credit offered to them, and get at practices of the credit industry that stack the deck against consumers.

Consumers Union, as well as a wide range of other organizations, including groups representing women and children, lower income consumers, labor, the victims of crimes, and the civil rights community, are concerned about the impact of bankruptcy on hardworking Americans.

One way to stem the number of bankruptcies is to help people avoid getting into trouble in the first place. Just because American families are using the bankruptcy system, does not mean that they are abusing the system. Rather, these are families facing job loss or downsizing, medical expenses they cannot afford to pay, and in some cases, these are women and children going through divorce. Not all have benefited in the same way from what has been characterized as these good economic times. In fact, many are just now seeing an increase in earnings, and income inequality between the top earners and the rest of the workforce appears to be increasing.

A new report from the Federal Reserve Bank of New York concluded that debt burdens among cardholders is the reason for the recent rise in bad debt. New borrowers are riskier (and more profitable for the credit industry as they get charged higher rates) owe substantially more relative to their income, so even small drops in income can cause financial distress. These borrowers are more likely to work in relatively unskilled jobs. Delinquencies are higher among such workers, the report found, because their income is more closely tied to the business cycle. Thus, a mild economic slowdown can trigger a rise in bad debt. It seems disingenuous for creditors to complain about the high number of bankruptcies when their behavior encourages bankruptcies.

FIRST, WORK TO RAISE ALL BOATS.

Provide hard working American families the tools they need to fully participate in society, including:

- Providing for meaningful health care and retirement security.
- Ensuring access to appropriate financial products through true marketplace competition and that taxpayer-backed financial institutions offer basic banking accounts.
- Eliminating scams that take money from consumers, and are often targeted at the elderly, minorities and lower income consumers.

SECOND, LEVEL THE PLAYING FIELD.

Credit card issuers can change the terms of the deal at any time. And they have, finding new ways to generate fee income by raising fees and changing other payment terms such as due dates and grace periods. Some may not know how much carrying a balance and making a minimum payment will cost them. Any reform should ensure consumers have adequate information about their choices with respect to consumer credit, responsible debtors are not penalized, and minors are protected. What can be done?

Enhance disclosures to consumers about the consequences of making minimum payments. Many lenders encourage minimum payments that do not pay down the loan. Currently, credit card statements, unlike mortgage loans and car loans, do not disclose the amortization rates or the total interest that will be paid if the cardholder makes only the minimum monthly payment. Using a typical minimum monthly payment rate on a credit card, it would take 34 years to pay off a $2,500 loan, and total payments would exceed 300 percent of the original principle. Jane Bryant Quinn quote. People don't understand how it works and the credit industry knows it and acts on it.

Ensure that no credit cards are provided to minors unless there is a demonstrated ability to repay or *a parent* or *other adult cosigns*. The credit industry has targeted students and minors with little or no income. Direct solicitation to both college and high school students have intensified. Cards are available to almost any student—

no income, no credit history and no parental signature required. What credit problems mean, continue to pay high interest if late on payment, raise cost of buying a home, etc.

> *"Targeting Teens: You Never Forget Your First Card!" Most teens never forget their first love. Nor do they forget the issuer who dares to accept their application. Their brand loyalty and propensity to spend make consumers in their mid- to late teens priced prospects for many card issuers." Agenda for Card Marketing Conference '98, November 9–11, 1998.*

Prohibit penalties or card cancellations for consumers who pay the full balance owed on a credit card in any month. Another way creditors increase their fee income is by penalizing consumers who pay off their balances. Several companies have instituted charges or even canceled credit cards for customers who pay in full each month, preferring customers with large credit balances who pay minimum monthly payments.

> *Rebecca had a MasterCard account with Mellon Bank for 14 years. She says that she had been "diligently paying off debt," so she had not used her card in some time, "and in fact had not been overly zealous in checking my bill." But last July, shoe looked at her statement and noticed a charge of approximately $50. When she called the bank to ask what the charge was for, she was told that Mellon was charging her for not suing her card in six months. The customer service representative advised her to use her card more often in order to avoid the charge, but Rebecca felt that her "$30 annual fee and interest on [her] remaining balance should be enough," so she told the representative that she was canceling her account. Though she had been a customer for so many years, no one tried to talk Rebecca out of the cancellation.*

Require full disclosure of security interests on credit card purchases that could lead to later threats of repossession of household items.

Enhance disclosure concerning "teaser" rates. Credit solicitations sometimes offer misleading "teaser rates of interest. Teaser rates are designed to encourage consumers to run up balances when the rate is low, but often the balances will inevitably be paid back at a much higher rate or hidden terms, such as one late payment, triggering higher rates.

THIRD, DO SOMETHING ABOUT THE ABUSIVE PRACTICES OF DEBT COLLECTORS.

People and families trying to work with their creditors to pay down their debts are sometimes turned away. Mr. Larry Nuss, testifying last week for the Credit Union National Association on bankruptcy reform stated that the action of debt collectors is a primary reason why people file for bankruptcy. It is unfair that on the one hand creditors argue that debtors are irresponsible, then shun those that seek to work out payment plans rather than avoid their debt. Moreover, it seems counterproductive to pursue aggressive collection activities that effectively drive those willing to continue to make payments into bankruptcy.

> *"Clients rate collection practices as the No. 1 reason why they file for bankruptcy," according to the National Foundation for Consumer Credit, Dogged by the Debt Collectors: Bankruptcy Often no Protection from Vicious Hounding: Negotiation is Fading Option, USA Today, Christine Dugas, Nov. 20, 1998.*

FOURTH, REEXAMINE THE NEED FOR REFORM.

- *The credit community has effectively removed the "stigma" of bankruptcy.* Perhaps a Texas court best summed this up:

> The court recently saw evidence that during the first two years of a five-year Chapter 13 plan; the debtors received 53 credit card solicitation. These actions and frequent advertisements by various creditors indicate that the credit community no longer shuns persons who take bankruptcy, but rather actively solicit their business. The credit community has effectively removed the "stigma" of bankruptcy. Bankruptcy judges and most bankruptcy lawyers have always advocated that bankruptcy be a last resort for those in financial difficulty. By making post-bankruptcy credit readily available, the credit community is encouraging those with financial difficulty to take bankruptcy. The credit community should not complain because its actions were successful and resulted in additional bankruptcy filings. *In re Bain*, 223 B.R. 343, 344 n2 (Bankr. N.D. Tex. 1998).

> *"Guaranteed Approved" Visa or MasterCard "Regardless of Past Credit History or Bankruptcy." Advertisement for credit cards from the Fair Credit Association.*

"Have banks turned their backs on you?" You qualify for a Capital One MasterCard "even if you've been turned down in the past." Advertisement for a Capital One credit card.

- *New information shows that fewer filing for bankruptcy can repay.* There is new information from the American Bankruptcy Institute that finds that only three percent of people who file under Chapter 7 can afford to repay their debt. This finding contradicts earlier industry funded studies that contend that a higher percentage of people filing for bankruptcy can repay.
- *There is nothing in the bill that requires that any cost savings from bankruptcy reform be passed on to consumers.*

CONCLUSION

It is vital to proceed with caution and deliberation. By allowing creditors to collect more debt, bankruptcy reforms could encourage credit card banks to market and extend credit more aggressively. Thus, it is quite possible that the reforms proposed could actually aggravate the problem of consumer financial insolvency.

To the extent that there is actual abuse of the system by those who have the ability to repay, perhaps now is the time to give more discretion to bankruptcy judges. At a minimum, careful consideration should be given to their suggestions as to how to make the system better. It is our understanding that the Committee will be hearing from bankruptcy judges in another panel.

Bankruptcy is complex and there are many other issues and controversies—child support and alimony, cramdowns, reaffirmations, creditor motions, dischargability. We will continue to work to resolve these issues in a reasonable way.

Once again, I want to thank you for the opportunity to appear before you today. Please let me know if we can be of any further assistance to the Committee.

Mr. GEKAS. Yes, we thank the gentleman.

We will now recess until 2:25 so that the members can report to the floor for the purpose of meeting—well, until 2:30, and if we are a little late, we are a little late. But we hope that the panel will stay the course until we can return and pose some questions.

With that, we recess until 2:30.

[Recess.]

Mr. GEKAS. The hour of the recess having expired, we will resume the subcommittee deliberations as soon as another member should appear, and so we recess again out of necessity.

[Recess.]

Mr. GEKAS. The time of the recess having expired and duly noting the attendance of the gentleman from Massachusetts, a hearing quorum has arrived and we can proceed with questions to be posed to our guests.

Will the gentleman from Massachusetts make his way to his——

Mr. DELAHUNT. I ask indulgence for 1 minute since I am meeting with some very valuable constituents.

Mr. GEKAS. But I wanted you to participate in the questions. I will sing a song until you get here.

[Pause.]

Mr. GEKAS. Well, let me begin the questions by asking Ms. Kubica something that I had always assumed, and I hope I am right. Does your credit union or any credit union strike a daily balance like the banks do, that is, strike a balance of assets on hand every single day at 4 o'clock or 4:30?

Ms. KUBICA. Well, we know what they are, but we don't produce reports of that on a daily basis.

Mr. GEKAS. You don't.

Ms. KUBICA. But we do know what the balances of our loans and what our assets are. We don't have occasion to prepare reports at our credit union. Maybe some of the other credit unions do that.

Mr. GEKAS. The reason I am asking is that it seems to me that one of the risks that are attendant to credit unions by increasing bankruptcies is that the balance with which you have assets to make further loans or to use is adversely affected each time a bankruptcy occurs. That has to be correct. Is that correct? That your total portfolio of assets diminishes when there is a bankruptcy?

Ms. KUBICA. Sure. If we have a bankruptcy, when it is discharged we need to write it off.

Mr. GEKAS. Right. And when you write it off, that means that there is no more income coming in from that account. Is that correct?

Ms. KUBICA. Exactly.

Mr. GEKAS. So that the estimated income total for the treasury in your credit union is diminished or does not enlarge?

Ms. KUBICA. It does reduce income.

Mr. GEKAS. Yes. Mr. Torres, the theory that I have not been able to penetrate—and I have tried thousands of ways to try to do it—is based on your predilection that we must do everything we can to disclose, to bring about full disclosure so that everybody who looks at the credit cards that are thrown his way will know exactly what he is getting into, that kind of thing, we are all in favor of all of that.

Short of that, you seem to be saying if we don't do that, if we don't disclose, if people don't understand, they won't understand that the answer is not to withdraw credit from them, that they cannot be trusted or cannot be given the right to have credit because we will not be able to make it clear to them what the consequences are of borrowing for a T.V. set or some kind of appliance.

There are forces at work against each other here. I want to allow the market to work in such a way that every poor person, every person, everybody in the country, will have access to credit.

You, who fear—fear—that the credit companies, the extenders of credit, the lenders, are going to be exploiting the poor people and thrusting credit where they don't have to have it, that is going to cause chaos among the exploitation of the poor.

Where do we balance this?

Mr. TORRES. Well, I think one of the ways to balance it is by adopting some of the things that, if I understood you correctly, you agree with as far as getting better information to disclose about the costs of their credit.

Mr. GEKAS. Yes.

Mr. TORRES. And I don't believe that that is inconsistent with making credit available to whoever qualifies for it. And I think now the credit unions do an awfully good job about underwriting their loans. But——

Mr. GEKAS. So that if a credit card company issues 100,000 credit cards but makes full disclosure to everybody, even following the pattern of disclosure that you wish to see adopted, you would have no objection to that kind of business practice. Is that correct?

Mr. TORRES. That is correct.

Mr. GEKAS. So that we still come back to whether you believe that there is anything in our bill that prevents a poor person or someone who cannot handle debt and has proven that it is so burdensome that there is no opportunity except to grant that individual a fresh start, do you believe there is anything in our bill that prevents that?

Mr. TORRES. Well, there are a lot of different components to your bill beyond just disclosing to people who are taking credit the risks that are associated with accepting that. I am certainly getting them more information, unlike now where there are teaser rates and some other things that Congressman LaFalce mentioned that consumers may not understand.

Mr. GEKAS. I am saying to you, Mr. Torres, in the hypothetical—I didn't make it clear. We are going to give you all the disclosures you want—LaFalce, Torres, and X—all the disclosures known to mankind. And they are placed in front of a poor person, a working man, woman, and nevertheless that person finds that the debts are over his head. Is there anything in our bill that indicates to you that that individual will not be granted a fresh start?

Mr. TORRES. Well, as I started to say before, there are lots of different components to your bill. I know that there is lots of concern about the way the means test will operate. There is concern about the way creditors will have a right to file——

Mr. GEKAS. Well, let's put the means test out of the equation by saying to you that this is under $51,000 for a family of four. It is a person who is earning $25,000 a year.

Now, he gets full disclosure under the Torres plan, under the LaFalce plan, under the best disclosure features possible, and he applies for bankruptcy. Is there anything in our bill that would prevent that individual from getting a fresh start that you know of?

Mr. TORRES. I think there are a number of things that we have concerns about. There are some concerns about how, if that person in your example is collecting child support or alimony payments, how that might affect the equation.

Mr. GEKAS. I don't think you understand, Mr. Torres. I have to——

Mr. TORRES. Maybe I am not understanding your question.

Mr. GEKAS. The question of support doesn't even come into the picture if the salary, the earnings, are under $51,000 for a family of four or under the median income for even an individual, which is somewhere in the $30,000 bracket. So here is an individual under that who has applied for a fresh start, and I am asking you to forget the support, forget all those things. We have the starting point as to whether the means test would apply. It doesn't even apply to a person at $20,000 or $25,000.

Can't we get that across to people that what we are interested in here is preserving the fresh start for low-income people, that we have not done one solitary thing in our bill to create a situation in which a person cannot get a fresh start when they are below a certain income and when they are overburdened with debt? If we can't have you acknowledge that, we can't get anywhere in trying to create a balance.

We are after the people over $51,000 for a family of four who can demonstrate or we feel can demonstrate an ability to repay some of the debt. That is what this bill is about. Do you oppose——

Mr. TORRES. We would agree that to the extent any bankruptcy reform effort gets at the abusers of the system, that something can be done there.

Mr. GEKAS. Well, I am little frustrated.

The gentleman—which one arrived first? The gentleman from Massachusetts, Mr. Delahunt, is recognized for 5 minutes.

Mr. DELAHUNT. Mr. Torres, if I can help, I think I know what the chairman is getting at. What you are suggesting is if we have the disclosures, the Torres disclosure, the LaFalce disclosures, then the likelihood is that the individual, being educated and informed, will make different decisions and will not find him- or herself in a situation where he or she is dealing with bankruptcy.

Mr. TORRES. That is correct.

Mr. DELAHUNT. I think that is the point, and, you know, if the chairman—if I am incorrect, I will stand corrected by the chairman. But the idea of disclosures is to let the consumer know what he or she is getting into. And, clearly, or at least to my satisfaction, that is not currently the case.

Mr. TORRES. That is correct.

Mr. DELAHUNT. Now, let me pose this question to Ms. Kubica as well as Mr. Torres. We talk about a fresh start. There currently exists in our bankruptcy statute, as it is applied to the States, a provision which allows certain exemptions for primary real estate, primary residences. We have a situation in some States—and to cite one example, because I read it just recently—Burt Reynolds, that famous actor, filed for bankruptcy, yet was able to retain his primary residence in which he had an equity in excess of $2 million—$2 million.

Now, I think everybody on this panel agrees that a fresh start is something that we all should encourage and support. At the same time, that is what I would call one hell of a fresh start because that is $2 million that can be leveraged via mortgages, home equity loans, what have you, after the bankruptcy is concluded, giving that particular individual, Mr. Reynolds in this case, an extraordinary advantage over others who find themselves in bankruptcy.

Would you support caps on the exemptions that are conferred on primary residences? Ms. Kubica?

Ms. KUBICA. Well, I think the situation that you are addressing with Mr. Reynolds is not the usual thing that we in our credit unions are seeing. We don't oppose fresh starts.

Mr. DELAHUNT. You support fresh starts, right.

Ms. KUBICA. We understand that there are going to be people that need that, who have filed bankruptcy for obvious reasons, whether it be medical——

Mr. DELAHUNT. No, no, and I agree. My question is: Do you support—to ensure fairness and equity and confidence in the bankruptcy system—a cap, whether it be $100,000 or $200,000 or $500,000 as opposed to a situation where an individual has accumulated tremendous equity in a home to a value of multi-multimillions?

Ms. KUBICA. At this time, the Credit Union National Association does not have a policy on the homestead exemption, but we certainly——

Mr. DELAHUNT. Well, just give me your opinion. I am not asking——

Ms. KUBICA. Opinion? Personal opinion, I think there should be some restraints. Everyone shouldn't be able to keep extraordinary amounts of real estate. There should be some——

Mr. DELAHUNT. Fairness.

Ms. KUBICA [continuing]. Standardization.

Mr. DELAHUNT. Well, thank you very much. I appreciate that.

Mr. Torres?

Mr. TORRES. One of the things that struck me when the bankruptcy debate first happened is one of the advertisements run by the coalition of industry players who were for bankruptcy reform, and it was a picture of a couple, all you could see was the feet, down at a beach in Florida saying, you know, look what happens. And it struck me that, you know, these are probably people taking advantage of the homestead exemption and shielding their assets. You know, isn't that exactly the type of abuse the bankruptcy reform effort, my understanding at the beginning, was supposed to be about? And yet it really doesn't address it. But a cap certainly would get to that and help stop people from using it as a true financial planning tool that maybe the wealthier can take advantage of but the people that are filing bankruptcy on a more day-to-day basis, not the Burt Reynoldses, but who have suffered a job loss or medical expense.

Mr. DELAHUNT. Mr. Chairman, in lieu of a second round—I know I said those magic words. Just one or two more questions, if I can.

Mr. GEKAS. If I would grant the gentleman an additional 2 minutes now, would he sacrifice the second round?

Mr. DELAHUNT. I am willing to sacrifice it, but I can't speak for Mr. Nadler.

Mr. GEKAS. Well, I can.

Mr. DELAHUNT. Or Mr. Watt. But just give me——

Mr. GEKAS. Let's leave it at a single round, but I will extend the time within reason.

Mr. DELAHUNT. Okay. Thank you, Mr. Chairman.

I don't know if you were both present when I polled the previous panel on my two questions, but I think this is important, and maybe you don't feel that you have the background to answer them, and I respect that because I certainly don't. But do you anticipate, if this legislation passes, that we will see a reduction in credit card interest rates?

Ms. KUBICA. No, I don't. I think that we may see a reduction in discharged debt, the amount that is being discharged, because there will be a little more control over what can be discharged.

I think we should see more wise use of credit, which we haven't talked about here a lot today or——

Mr. DELAHUNT. By the way, let me interrupt by saying I really agree with your testimony regarding the need for counseling, particularly prior to bankruptcy filings, and I think it is really important. And if I can just jump to Mr. Torres on the interest rate issue.

Mr. TORRES. No, I wouldn't anticipate interest rates to come down. As the earlier testimony indicated by the other panel, and what I have read outside of that, just the way industry works, you know, one isn't necessarily related to the other.

Mr. DELAHUNT. One final question, and this is address to both of you. If this legislation passes, do you expect the number of personal bankruptcy filings to diminish, to go down?

Ms. KUBICA. I would say speaking for our members, yes. If there were more audits and things of that nature that are described in the bill, people wouldn't be as inclined to just take that route if they knew they had more accountability for their income, their expenses.

Mr. DELAHUNT. Thank you.

Mr. Torres?

Mr. TORRES. I don't believe that the number of bankruptcy filings would go down, but perhaps more importantly, it really wouldn't do anything to solve the problem that we have with consumer debt. So we would still have families in financial crisis. They may not be able to take use of the bankruptcy system, and so what do they do if they simply cannot repay their debts.

Mr. DELAHUNT. Thank you.

Thank you, Mr. Chairman.

Mr. GEKAS. The gentleman from New York is recognized for 5 minutes. Then we will recognize the gentleman from North Carolina and the other gentleman from New York in that order.

Mr. NADLER. Thank you.

I would like to continue, Ms. Kubica, with Mr. Delahunt's line of questioning. You don't anticipate, you stated a moment ago, that interest rates would go down if this bill passed. That is what you said, right?

Ms. KUBICA. Yes.

Mr. NADLER. Okay. So, in other words, the statement by the supporters of this bill that this bankruptcy problem costs every consumer $550 a year presumably in unnecessarily high interest costs is wrong. Correct? In fact, it doesn't cost them a nickel because interest rates won't go down in any event?

Ms. KUBICA. When this was being discussed earlier, I had a concern that maybe it was being zeroed in on that one thing. And our management practices at our credit union are to look at the big picture, not just one area.

Mr. NADLER. Well, I understand that. So, in other words, what you are saying is that whatever the interest rates are, it isn't because of the bankruptcy crisis. And if this bill passes, the interest rates won't change as a result of that bill. And, therefore, if, in fact, the bankruptcy crisis is costing consumers $550, this bill won't change that. It is an obvious consequence of what you are saying.

Mr. GEKAS. Would the gentleman yield for a moment?

Mr. NADLER. Yes, I will.

Mr. GEKAS. We believe that you may be posing an inaccurate supposition to the lady because the $500 loss per person that we claim could come out of leaving the situation as it is. It is not composed only of interest rates, but other factors also enter into that loss.

Mr. NADLER. Reclaiming my time, after 2 years of debating this bill, I have never heard of anything other than interest rates. That is what always was cited.

Mr. Torres, would you answer the question, please, briefly?

Mr. TORRES. Sure. Like I said, there is nothing in the bill that requires——

Mr. NADLER. Can't hear you. Pull your mike. There is what?

Mr. TORRES. There is nothing in this bill that requires any type of payback. I don't imagine interest rates coming down, and the way that the debate has been going, it has been touted as a $550 tax on American families, and why not expect a check in the mail if this——

Mr. NADLER. And you don't see that at all?

Mr. TORRES. No. And there is nothing in the past practices of the credit industry that would seem to indicate that they would take it upon themselves to probably do the——

Mr. NADLER. There is nothing to indicate that any increased collections on their part would go anywhere but to the bottom line.

Mr. TORRES. Exactly.

Mr. NADLER. It wouldn't be returned to consumers.

Mr. TORRES. Exactly.

Mr. NADLER. Thank you.

Ms. Kubica, you state in your testimony on page 4, "We are aware of concerns of abusive creditor practices, recently highlighted in high-profile press coverage, but note that the current Bankruptcy Code, in fact, caught the violators. The size of the penalties imposed will undoubtedly act as a deterrent to others."

You are talking, among other things, for instance, of the Sears case, I assume.

Ms. KUBICA. Yes.

Mr. NADLER. Thank you.

Are you aware that among the provisions of this bill is a ban on class actions in this case so that if Sears did it again, they would get away scot-free and there would be no recovery whatsoever?

Ms. KUBICA. I think as I testified, they were caught and they——

Mr. NADLER. Well, they were caught under the current Code, but under this bill they wouldn't be caught because this bill bans class action suits such as the class action suit that caught Sears. Under this bill, Sears would continue on its merry way, and you couldn't sue them unless some individual could sue them for $30 and hire a lawyer for a few tens of thousands of dollars to recover the $30.

So, in other words, what you are saying is that the current system works to protect against abusive creditor practices. I don't agree, but, granted, to the extent it works, this bill would stop it from working because it would stop one of the major enforcement mechanisms, which is the one you specifically cite by citing the size of the penalties, no more penalties because no more class action suits—one of the less publicized provisions of this obnoxious bill.

Mr. GEKAS. What kind of bill?

Mr. NADLER. Obnoxious.

Mr. GEKAS. How do you spell that?

Mr. NADLER. O-b-n-o-x-i-o-u-s, and it is spelled out on every page of this bill.

Let me ask you one thing, Mr. Torres. Most of the debate today or the discussion today has been in the form of a lot of generalized testimony, pro and con, on the means test. Last week we heard a number of witnesses say that the means test, while excellent or terrible, depending on your point of view, just isn't that important. It is only going to affect a few people one way or the other. The proponents say, well, you know, with the median income, it is only affecting X number of people. Even the opponents concede basically it doesn't affect that many people.

But we had a number of witnesses who said, listen, this is, I think it was, a 302-page bill, and if you took out the 20 pages or the 2 pages, or whatever it is, on the means test, every other page of this bill has provisions tilting the playing field against debtors for creditors on a million different provisions. And it is all those other provisions, not the means test, which have not gotten all the debate that really makes this a terrible bill.

Would you comment on that observation?

Mr. TORRES. Certainly. In addition to the things that you mentioned, there is everything in from having to disclose your past tax returns to make them available to any interested party for copying, which to me makes it seem as though it is just available to the world. You might as well post your tax returns on the World Wide Web.

There is a large number of provisions that would allow for creditor motions for people who are going through financial crisis and don't have the money to pay their debts, even though they probably struggled to do so but got caught up because a debt collector wouldn't let them work out a pay-out plan. So you have got to struggle to get an attorney so that you can combat all these motions.

You know, clearly there is a lot of things in this bill that would make it very difficult for people to stay within the bankruptcy system.

Mr. NADLER. Let me ask you two other questions in my extended 5 minutes, both brief.

We heard testimony last week—and I want to see if you agree with it—that, in fact, under this bill you can fail the means test and be too rich, in effect, to have Chapter 7 relief and be forced from Chapter 7 into Chapter 13, and then not have enough money, disposable income under the means test, to be able to pay the various mandatory things that have to be paid, $50, whatever those other requirements are, to unsecured creditors so that a plan couldn't be confirmed, so that, in effect, there will be people who are too rich for Chapter 7 and too poor for Chapter 13 and, therefore, can't get any relief at all.

Is that correct, or am I missing something?

Mr. TORRES. That is my understanding of how it would work for some, yes.

Mr. NADLER. So some people could be forced out of Chapter 7 into Chapter 13, but then not have enough money to be able to have a plan under Chapter 13.

Mr. TORRES. Exactly.

Mr. NADLER. And, therefore, they would be stuck in limbo forever.

Mr. TORRES. Right. Prey for the credit industry.

Mr. NADLER. What?

Mr. TORRES. Prey for the credit industry.

Mr. NADLER. Prey for the credit industry.

And my last question is: You testified about various consumer protections and disclosures that you think should be added to the bill. And, of course, some of these consumer amendments were in the Senate bill last year, and they were taken out or gutted in this bill, or at least in my opinion they were. The sponsors of this legislation insist that some of those provisions are retained in this bill and would, in fact, provide consumers with helpful information.

My question is: Is this true? To the extent that the Senate consumer amendments were changed in conference last year, resulting in the provisions in this bill, is anything useful left of them? Are there useful consumer provisions in this bill, or are they just window dressing, and do they approach—or are they, in fact, even worse, misleading?

Mr. TORRES. They are worse. They were not only gutted, but they were made misleading. In particular, one of the most important provisions that made it through the Senate bill last year dealt with providing consumers, users of the credit, basically the amortization of their credit on their statement. Instead what we ended up with in the conference report was kind of some boilerplate language using $500, I believe, as the amount that gets amortized as kind of a general boilerplate language, which is misleading because that is not what the person may be carrying on their credit card, and if that amount is higher, they could say, oh, well, you know, the minimum payments, you know, I am comparing it to this $500, I can make it, everything is fine.

Mr. NADLER. In other words, in the Senate bill you had a provision that showed what you would have to pay and how much it would come to based on your situation. And what is in this bill is based on a hypothetical consumer with a hypothetical $500 debt, which might be misleading as to the consequences for you with a debt of X or Y or Z.

Mr. TORRES. Exactly. Exactly. I mean, the whole purpose of this was to give people a real-time example of where they are. You are carrying this amount of credit. If you simply make the minimum payments, here is how long it will take you to pay off this debt, and here is how much you will have to pay at the end of the day.

Mr. NADLER. And the purpose of that was to show people how deep they are getting in so they can avoid bankruptcy, and the provision here, would that do that? Would that show people how deep they are getting in? Would it help them avoid bankruptcy or not?

Mr. TORRES. Absolutely not. By giving some boilerplate language and calling for a Federal Reserve study doesn't help most consumers to understand how deep they are getting in, because it is not them, it is a boilerplate provision.

Mr. NADLER. Thank you very much.

Mr. GEKAS. The gentleman from North Carolina is recognized.

Mr. WATT. Thank you, Mr. Chairman.

Ms. Kubica, you suggested in your statement that you are a strong believer in consumer credit counseling, and so am I. I guess a more difficult question, though, is the point at which one gets consumer credit counseling and whether it is helpful or as helpful as it could be.

I want to read you a comment from one of the witnesses' statements who is going to testify tomorrow and ask you if you would respond to it. It says: "Section 302's requirement that debtors receive credit counseling as a condition to eligibility for bankruptcy will work a hardship on many debtors without providing any substantial benefit to creditors." And then the explanation for that statement goes on to say: "Virtually everyone agrees that instruction in personal financial management is sorely lacking in our society. But a recent survey of over 5,000 cases in 46 different judicial districts indicates that the average bankruptcy debtor is so far in debt that credit counseling on the eve of bankruptcy would be a useless exercise for most debtors and creditors alike. The question of mandatory credit counseling should be revisited after the financial management pilot program, which is required under Section 104 of the bill, is completed."

Would you just give me your comments in response to what this witness is going to say tomorrow, I believe.

Ms. KUBICA. You are referring to the time frames not being reasonable enough?

Mr. WATT. Yes.

Ms. KUBICA. At our credit union, we try to get that message out to people all of the time when they come in and apply for any type credit.

Mr. WATT. And I agree with you that that is a very good policy. I guess what I am asking you to comment on is the mandatory nature of this credit counseling and the timing of the credit counseling.

Ms. KUBICA. Well, I believe that it would help. There could be times where maybe they do have a lot of debt, but I think with the right encouragement and information as to how to handle the finances and contact their creditors, a lot of creditors are willing to work with people to enable them being repaid rather than declaring bankruptcy.

Mr. WATT. Let me ask you about the demographics of—you attached a fact sheet, page 10 of your statement, which talks about your bankruptcy experience of your credit union from 1994 through 1998, and the losses due to bankruptcy from 1994 through 1998. But I noticed that the total assets and members and total loans is a stagnant figure. It is not a figure that you gave us the information for from 1994 through 1998.

How much variation has there been in the total assets and your total membership and your total loans over that period of time?

Ms. KUBICA. From 1994 through 1998, of course, I don't have the numbers in front of me, but just a ballpark number, assets have probably grown since 1994 by several million dollars.

The number of members is usually in the same ballpark. It varies. You gain some and lose some. It has grown a small amount during the last number of years.

The loan portfolio has some ups and downs once in a while, but it is fairly stable, also.

Mr. WATT. So you are saying your total loans in 1994 would have been essentially $14.5 million also?

Ms. KUBICA. Give or take maybe a 10 percent difference in that.

Mr. WATT. I noticed in your losses due to bankruptcy, you had the most substantial losses in 1997, and then they are back down substantially in 1998, almost $45,000 lower in that 1-year period.

Is it just the size of the loans that you had of the people who were declaring bankruptcy that accounts for that?

Ms. KUBICA. No. The decrease—in 1997, we charged off several large losses which I alluded to in my testimony. Actually, in 1998, the numbers have declined. However, there have been more filings than what you are seeing as charged off. We don't——

Mr. WATT. So these are charge-off figures, not necessarily——

Ms. KUBICA. For bankruptcy, yes, definitely losses for bankruptcy. We don't incur that loss until it is actually discharged.

Mr. WATT. Charged off, yes.

Ms. KUBICA. We always feel there is some hope that things might change and a person may pay us if we wait. But there were more filings in 1998. They just have not been charged off. But overall they have decreased in 1998.

Mr. WATT. Well, now, I am not cross-examining you. I am just trying to get a clearer understanding here. I thought if you look at the number from 1997, there was 16 total filings, which went down to 15 in 1998. Are you saying that there was an increase from 1997 to 1998?

Ms. KUBICA. In filings?

Mr. WATT. Filings, yes. I am looking at the bottom part of the fact sheet, page 10 of your testimony.

Ms. KUBICA. Well, from 1997 to 1998 on the fact sheet, there was just one difference. Where you see the—why it is different is the number of filings were very much the same, but the amount that we lost, we don't incur that loss until we are sure that it is definitely a loss.

Mr. WATT. So you are saying the $20,625 figure in 1998 is probably a substantial understatement because there are still people——

Ms. KUBICA. Right.

Mr. WATT [continuing]. Working their way through the process.

Ms. KUBICA. Exactly.

Mr. WATT. Okay.

Ms. KUBICA. Some have been charged off in early 1999, but overall——

Mr. WATT. I understand.

Ms. KUBICA [continuing]. It is less, and I would attribute that to more education by the credit union of bankruptcy and using credit better.

Mr. WATT. Thank you, Mr. Chairman.

Mr. NADLER. Mr. Chairman?

Mr. GEKAS. Yes, the gentleman from New York.

Mr. NADLER. Thank you, Mr. Chairman.

A little while ago, I characterized the bill before us as, with a rather harsh word, "obnoxious." And on sober second thought, I probably should have—that word is ill-advised. What I meant to convey was in my opinion the bill is harmful in the extreme and lacking redeeming social value, which I think is perhaps a better way of putting it.

Mr. GEKAS. I think I like "obnoxious" better. [Laughter.]

Mr. GEKAS. I thank the gentleman for clarifying that.

We acknowledge the presence of and ask that the record reflect the attendance of the lady from Wisconsin, Ms. Baldwin, who is a member of the subcommittee and who has participated in these debates heretofore.

With that, we extend our warm thanks to the panel and warn them that we will be seeking more information from them and posing further questions to them as this process moves along. So we are grateful, and we stand in recess and adjourn.

[Whereupon, at 3:36 p.m., the subcommittee was adjourned.]

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